

*The Department of the Treasury*  
MANAGEMENT'S  
DISCUSSION & ANALYSIS





# INTRODUCTION

Fiscal year 2008 has been a challenging year. The ongoing housing correction has reverberated throughout the U.S. financial system and severely impacted the U.S. economy. Lack of confidence among lenders and strained capital markets have made it harder to obtain student loans, auto loans, home loans and business loans. Restoring confidence in capital markets is essential to the long-term health of the U.S. economy. Treasury has made significant efforts this year to address financial market difficulties and mitigate effects on the overall economy. The list below constitutes some of the actions taken by the Department:

- Led the government response to financial market challenges
- Participated in development and implementation of the *Economic Stimulus Act of 2008*
- Helped homeowners by supporting creation of the HOPE NOW alliance
- Participated in finding solutions for troubled non-depository financial institutions
- Contributed to placement of Fannie Mae and Freddie Mac in conservatorship
- Proposed legislation allowing Treasury to increase liquidity in financial markets
- Implemented measures to bolster regulation of national banks and thrifts
- Established a Temporary Guarantee Program for money market funds
- Released the *Blueprint for a Modernized Financial Regulatory Structure*
- Participated in Federal Housing Administration modernization
- Participated in the development and implementation of temporary tax relief for mortgage holders
- Issued the *Best Practices for Residential Covered Bonds*
- Coordinated the U.S. policy agenda for the U.S.-China Strategic Economic Dialogue

All of these actions are aimed at implementing the Department's strategy to address the four key challenges financial markets face today - confidence, capital, systemic risk and liquidity. It will take time for these actions to have their full effect. Treasury will move aggressively on all possible fronts to address ongoing market and economic challenges.

Treasury's Offices of the Assistant Secretary for Management and Chief Financial Officer, the Deputy CFO, the Deputy Assistant Secretary for Management and Budget, and other Treasury bureaus and policy offices, in coordination with the Office of Financial Stability (OFS), are working through the financial and accounting aspects of the *Emergency Economic Stabilization Act of 2008* (EESA) over which the Department of the Treasury has authority, including the Troubled Asset Relief Program (TARP). The TARP includes a Capital Purchase Program, a Systemically Significant Failing Institutions Program, and may in the future include other programs to purchase troubled assets plus an insurance program as required under EESA.

- Value the various types of assets to be purchased under the TARP's authority
- Model the associated cash flows related to the assets to be purchased under the TARP's authority
- Report the TARP accurately, fairly, and transparently on the OFS's and the Department's financial statements in accordance with Generally Accepted Accounting Principles (GAAP)
- Account for capital infusions and equity positions in publicly traded banks under the Capital Purchase Program
- Account for programs that insure money market funds

Treasury will work with its partners to determine fair market value of the assets it purchases through the TARP program. This work began in early fiscal year 2009. Treasury plans to work closely with the Federal Accounting Standards Advisory Board (FASAB) to ensure that TARP financial reporting maintains consistency with appropriate accounting and financial reporting standards.

While there have been significant accomplishments in fiscal year 2008, much work remains to implement Treasury's new authorities. The Department will exercise proper stewardship and provide exceptional accountability and transparency to perform its work on behalf of the American people. This work is accomplished through Treasury's talented and dedicated workforce.

## ORGANIZATION

**The Department of the Treasury** is the executive agency responsible for promoting economic prosperity and ensuring the financial security of the United States. The Department is organized into two major components, the departmental offices and the bureaus. The departmental offices are primarily responsible for policy formulation, while the bureaus are primarily the operating units of the organization.

### Departmental Offices

**Domestic Finance** advises and assists in areas of domestic finance, banking, and other related economic matters. In addition, this office develops policies and guidance for Treasury Department responsibilities in the areas of financial institutions, federal debt finance, financial regulation, capital markets, financial management, fiscal policy and cash management decisions.

**International Affairs** advises and assists in the formulation and execution of U.S. international economic, financial, monetary, trade, investment, bilateral aid, environment, debt, development and energy policy, including U.S. participation in international financial institutions.

**Terrorism and Financial Intelligence** marshals the Department's intelligence and enforcement functions with the twin aims of safeguarding the financial system against illicit use and combating rogue nations, terrorist facilitators, money launderers, drug kingpins, and other national security threats.

**Economic Policy** reports on current and prospective economic developments and assists in the determination of appropriate economic policies. The office is responsible for the review and analysis of domestic economic issues and developments in the financial markets.

**Tax Policy** develops and implements tax policies and programs, reviews regulations and rulings to administer the Internal Revenue Code, negotiates tax treaties and provides economic and legal policy analysis for domestic and international tax policy decisions. Tax policy also provides revenue estimates for the President's budget.

**Treasurer of the United States** advises the Secretary on matters relating to coinage, currency, and the production of other financial instruments. The Treasurer also serves as one of the Department's principal advisors and a spokesperson in the area of financial literacy and education.

**The Community Development Financial Institutions Fund (CDFI)** expands the capacity of community development financial institutions and community development entities to provide credit, capital, tax credit allocations, and financial services to underserved domestic populations and communities.

**The Office of Small and Disadvantaged Business Utilization** assists, counsels, and advises small businesses of all types: disadvantaged, women-owned, veteran-owned, service-disabled veteran-owned, and small businesses located in historically

underutilized business zones on procedures for contracting with Treasury.

Internally, the Treasury's Departmental Offices are responsible for the overall management of the Department. The *Office of the Assistant Secretary of Management and Chief Financial Officer* is responsible for internal management and controls. Support organizations include *General Counsel*, *Legislative Affairs*, and *Public Affairs*. Also, two inspectors general, the *Treasury Inspector General for Tax Administration* and the *Office of the Inspector General* provide independent audits, investigations, and oversight to the Department of Treasury and its programs.

## Bureaus

Bureaus employ 98 percent of Treasury's workforce and are responsible for carrying out specific operations assigned to the Department.

### **The Alcohol and Tobacco Tax and Trade Bureau**

(TTB) collects excise taxes on alcohol, tobacco, and firearms that are lawfully due the government, protects consumers of alcoholic beverages through voluntary compliance programs that are based on education and enforcement to ensure a fair marketplace, and assists industry members in understanding and complying voluntarily with federal tax, product, and marketing requirements.

**The Bureau of Engraving and Printing (BEP)** designs and manufactures high quality notes and other financial documents that deter counterfeiting and meet customer requirements for quality, quantity, and performance.

**The Bureau of the Public Debt (BPD)** borrows the money needed to operate the federal government through the sale of marketable, savings, and special purpose U.S. Treasury securities. In addition, it accounts for and services the public debt and provides reimbursable support services to federal agencies.

### **The Financial Crimes Enforcement Network**

(FinCEN) safeguards the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity.

**The Financial Management Service (FMS)** provides central payment services to federal program agencies, operates the federal government's collections and deposit systems, provides government-wide accounting and reporting services and manages the collection of delinquent debt owed to the U.S. Government.

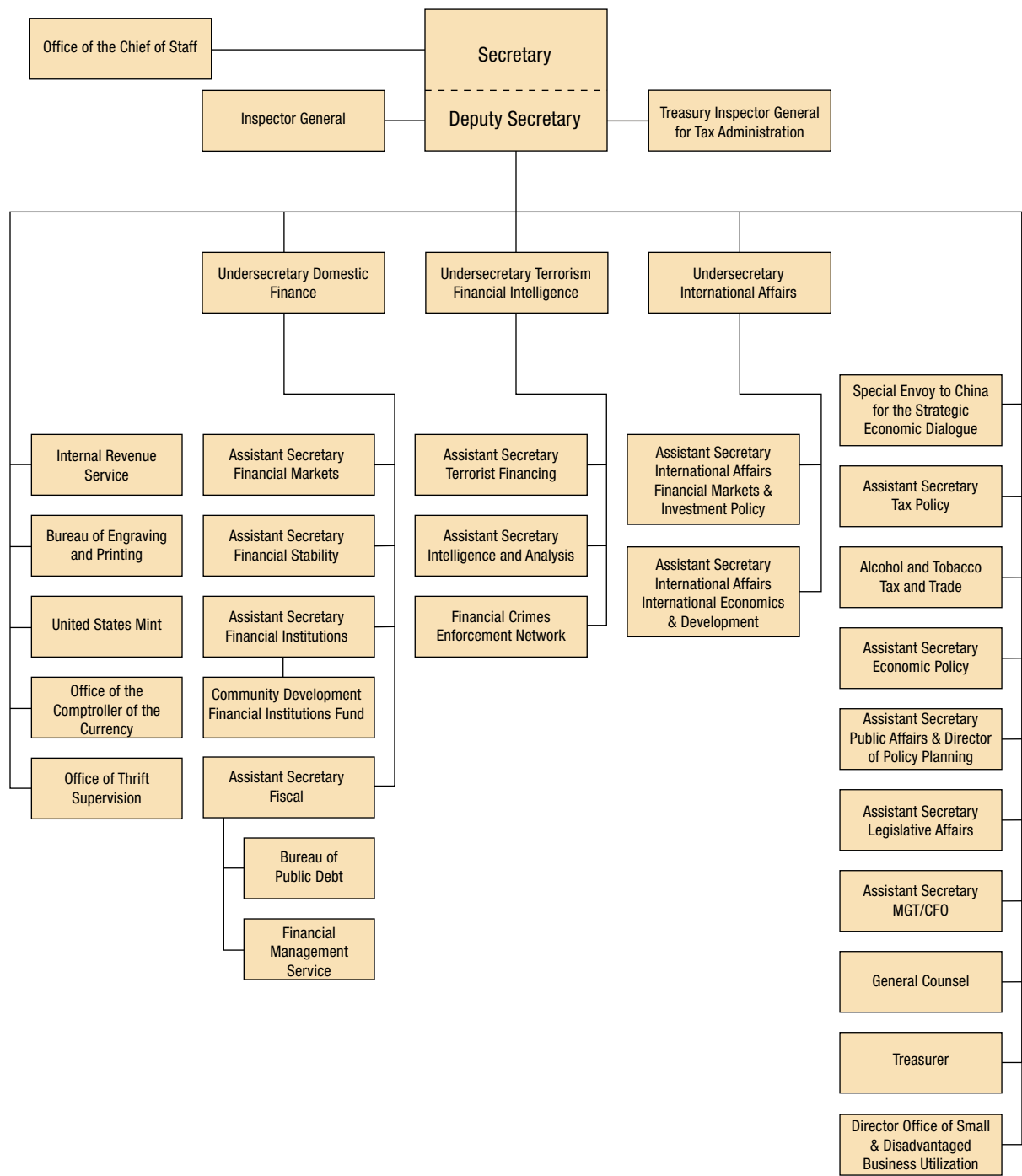
**The Internal Revenue Service (IRS)** is the largest of the Department's bureaus and determines, assesses, and collects tax revenue for the federal government.

**The United States Mint** designs, produces, and issues circulating and bullion coins, numismatic coins and other items, Congressional gold medals, and other medals of national significance. The United States Mint maintains physical custody and protection of the nation's gold assets.

**The Office of the Comptroller of the Currency (OCC)** charters, regulates, and supervises national banks to ensure a safe, sound, and competitive banking system that supports citizens, communities, and the economy.

**The Office of Thrift Supervision (OTS)** charters, examines, supervises, and regulates federal and many state-chartered thrift associations in order to maintain their safety and soundness and compliance with consumer laws.

THE DEPARTMENT OF THE TREASURY ORGANIZATIONAL CHART



# THE TREASURY DEPARTMENT'S 2007-2012 STRATEGIC FRAMEWORK

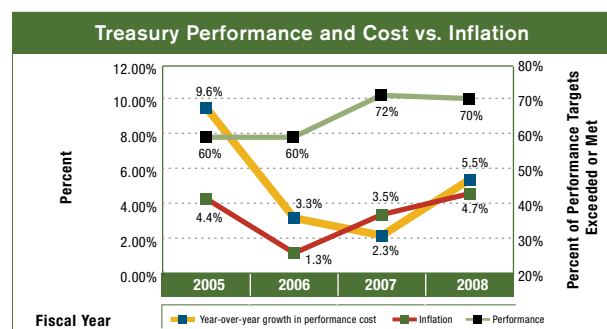
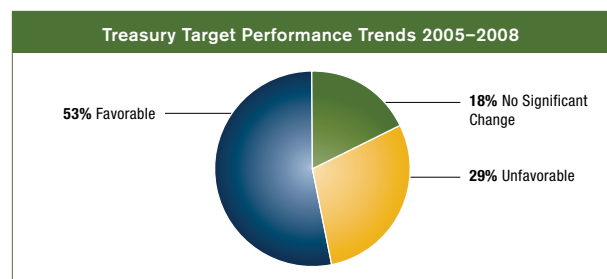
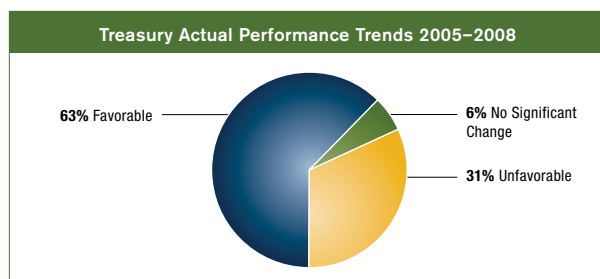
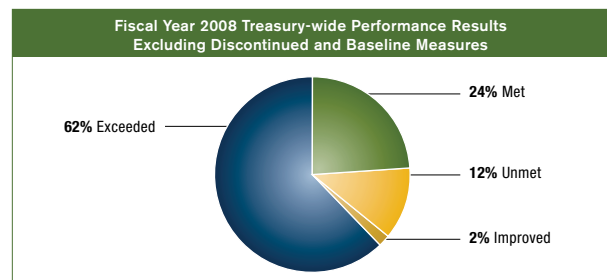
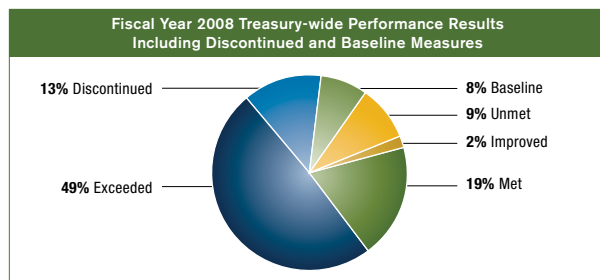
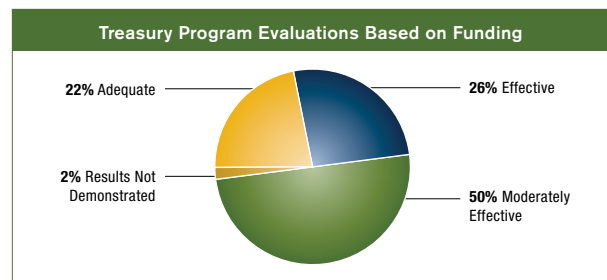
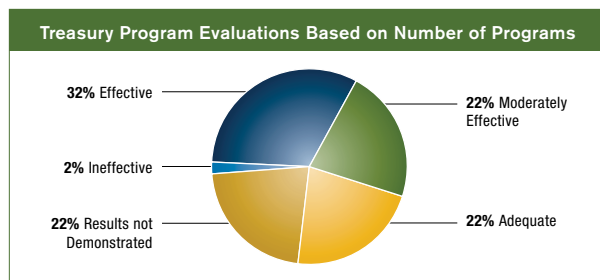
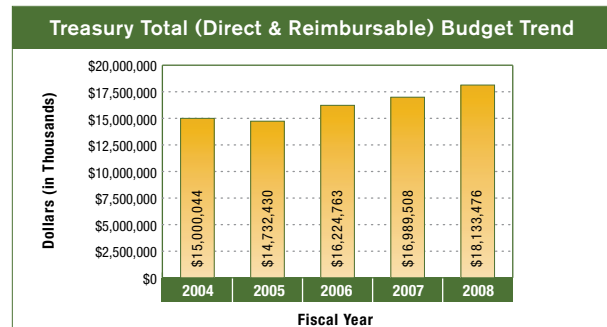
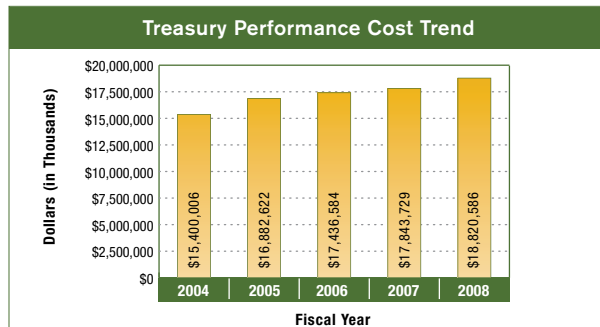
The Treasury Department's *Strategic Framework* is a summary of our goals, objectives, and outcomes. This framework provides the basis for performance planning and continuous improvement.

	Strategic Goals	Strategic Objectives	Value Chains**	Value Chain Outcomes
Financial	Effectively Managed U.S. Government Finances	Available cash resources to operate the government	Collect Disburse Borrow Account Invest	<ul style="list-style-type: none"> <li>Revenue collected when due through a fair and uniform application of the law at the lowest possible cost</li> <li>Timely and accurate payments at the lowest possible cost</li> <li>Government financing at the lowest possible cost over time</li> <li>Effective cash management</li> <li>Accurate, timely, useful, transparent and accessible financial information</li> </ul>
Economic	U.S. and World Economies Perform at Full Economic Potential	Improved economic opportunity, mobility and security with robust, real, sustainable economic growth at home and abroad	Strengthen Regulate	<ul style="list-style-type: none"> <li>Strong U.S. economic competitiveness</li> <li>Free trade and investment</li> <li>Decreased gap in global standard of living</li> <li>Competitive capital markets</li> <li>Prevented or mitigated financial and economic crises</li> </ul>
		Trust and confidence in U.S. currency worldwide	Manufacture	<ul style="list-style-type: none"> <li>Commerce enabled through safe, secure U.S. notes and coins</li> </ul>
Security	Prevented Terrorism and Promoted the Nation's Security Through Strengthened International Financial Systems	Pre-empted and neutralized threats to the international financial system and enhanced U.S. national security	Secure	<ul style="list-style-type: none"> <li>Removed or reduced threats to national security from terrorism, proliferation of weapons of mass destruction, narcotics trafficking and other criminal activity on the part of rogue regimes, individuals, and their support networks</li> <li>Safer and more transparent U.S. and international financial systems</li> </ul>
Management	Management and Organizational Excellence	Enabled and effective Treasury Department	Manage	<ul style="list-style-type: none"> <li>A citizen-centered, results-oriented and strategically aligned organization</li> <li>Exceptional accountability and transparency</li> </ul>
** Value Chains – Programs grouped by a common purpose.				

# FISCAL YEAR 2008 SUMMARY OF PERFORMANCE BY STRATEGIC GOAL

Strategic Goal	Key Accomplishments	Key Challenges	Trend
<b>Effectively Managed U.S. Government Finances</b>  <b>Cost*:</b> 2007: \$13.3 Billion 2008: \$14.0 Billion	<ul style="list-style-type: none"> <li>Collected \$2.74 trillion in tax revenue and \$14.6 billion in federal excise taxes on tobacco, alcohol, firearms and ammunition</li> <li>Processed 98.5 million tax returns electronically, up 10 percent over 2007</li> <li>Administered 116.2 million payments under the Economic Stimulus Act of 2008</li> <li>Conducted more than 200 auctions resulting in the issuance of more than \$5.6 trillion in marketable Treasury securities</li> <li>Resumed issuance of the 52-week bill on a monthly basis in order to finance budget deficit projections</li> <li>Reduced the minimum bid at Treasury auctions from \$1,000 to \$100</li> </ul>	<ul style="list-style-type: none"> <li>Continue to work toward the Congressional goal of having 80 percent of tax returns filed electronically</li> <li>Continue to convert from paper to electronic savings bonds</li> <li>Meet the long-term goal to have 90 percent of payments made electronically</li> <li>Reduce the use of illegal international tax shelters</li> <li>Reduce the erroneous payments rate within the Earned Income Tax Credit (EITC) program</li> </ul>	Performance ▲  Budget ▲  Cost ▲
<b>U.S. and World Economies Perform at Full Economic Potential</b>  <b>Cost:</b> 2007: \$3.2 Billion 2008: \$3.7 Billion	<ul style="list-style-type: none"> <li>Participated in development and implementation of the <i>Economic Stimulus Act of 2008</i></li> <li>Helped homeowners by supporting creation of the HOPE NOW alliance</li> <li>Participated in finding solutions for troubled non-depository financial institutions</li> <li>Contributed to placement of Fannie Mae and Freddie Mac in conservatorship</li> <li>Proposed legislation allowing Treasury to increase liquidity in financial markets</li> <li>Implemented measures to bolster regulation of national banks and thrifts</li> <li>Established a Temporary Guarantee Program for money market funds</li> <li>Released the <i>Blueprint for a Modernized Financial Regulatory Structure</i></li> <li>Participated in Federal Housing Administration modernization</li> <li>Participated in the development and implementation of temporary tax relief for mortgage holders</li> <li>Issued the <i>Best Practices for Residential Covered Bonds</i></li> <li>Coordinated the U.S. policy agenda for the U.S.-China Strategic Economic Dialogue (U.S.-China SED)</li> <li>Contributed to reform initiatives at the International Monetary Fund (IMF), World Bank and other international financial institutions</li> <li>Participated in finalization of proposed rules for U.S. Basel II implementation</li> <li>Provided loans, investments, financial services and technical support through the CDFI Fund</li> </ul>	<ul style="list-style-type: none"> <li>Continue to mitigate risks at national banks and thrifts</li> <li>Restructure regulatory institutions to improve supervision of financial markets</li> <li>Reform Medicare and Social Security to ensure long-term solvency</li> <li>Maintain open economies despite rising protectionist interests</li> <li>Improve productivity management relating to the printing and engraving of currency notes</li> <li>Improve supply management for bullion coin production</li> <li>Manage cost issues related to the penny and nickel</li> </ul>	Performance ►  Budget ▲  Cost ▲
<b>Prevented Terrorism and Promoted the Nation's Security Through Strengthened International Financial Systems</b>  <b>Cost:</b> 2007: \$537 Million 2008: \$555 Million	<ul style="list-style-type: none"> <li>Persuaded a number of the world's leading financial institutions of the risks of dealing with Iran and Iranian banks</li> <li>Designated and blocked key Zimbabwe regime supporters</li> <li>Completed actions targeted at the Revolutionary Armed Forces of Columbia (FARC)</li> <li>Led efforts within the Financial Action Task Force (FATF)</li> <li>Increased collaboration within the Intelligence Community</li> <li>Implemented efforts to increase Bank Secrecy Act (BSA) effectiveness and efficiency</li> </ul>	<ul style="list-style-type: none"> <li>Fully implement anti-money laundering and counter-terrorist financing (AML/CFT) laws in key countries</li> <li>Establish an external validation process to justify performance results</li> </ul>	Performance ▲  Budget ▲  Cost ▲
<b>Management and Organizational Excellence</b>  <b>Cost:</b> 2007: \$763 Million 2008: \$508 Million	<ul style="list-style-type: none"> <li>Issued 179 audits reports that produced financial accomplishments of \$2.4 billion</li> <li>Provided integrity and fraud awareness presentations to more than 90,000 IRS employees and educated tax professionals by providing awareness presentations to tax practitioners and preparers</li> <li>Created the Office of Privacy and Treasury Records (PTR)</li> <li>Established two Human Capital performance measures</li> </ul>	<ul style="list-style-type: none"> <li>Improve security configuration management</li> <li>Provide effective corporate leadership and accountability to improve performance between corporate, bureau, and program office management</li> <li>Complete an increased number of Material Loss Reviews (MLRs)</li> <li>Remain at last year's levels for the President's Management Agenda (PMA) Initiatives</li> </ul>	Performance ►  Budget ▼  Cost ▼
* Cost is stated as "Performance Cost", and represents imputed costs, depreciation, losses, and other expenses not requiring budgetary resources. A full definition can be found in the Introduction to Part 2.			

# HOW WELL IS TREASURY PERFORMING?



## HOW WELL IS TREASURY PERFORMING DISCUSSION

### Performance Cost and Budget Trends

Performance cost represents the best indication of the total cost to operate the Treasury Department. It includes normal operating expenses as well as imputed costs, depreciation, losses, and other expenses not requiring budgetary resources. Performance cost on the average has risen four to five percent per year since 2004. The Department's total budget, which includes direct appropriations and reimbursable amounts, has also risen an average of four to five percent per year since 2004.

### Program Evaluations

A total of 37 of Treasury Department programs have been evaluated using the Office of Management and Budget's Program Assessment Rating Tool (PART) since 2002. Each program receives a rating of effective, moderately effective, adequate, results not demonstrated, or ineffective. Results for all program evaluations are shown in two different charts. One chart is based on the number of programs, and the other on program funding. Programs receiving an adequate or better rating were 76 percent using the number of programs, but 98 percent based on program funding.

### Performance to Target

In fiscal year 2008, the Treasury Department revised its performance rating system. Performance to target was rated as exceeded, met, improved from the prior year (but not met), unmet, baseline or discontinued. Prior to this, performance measures were rated only as met or unmet. Results are shown in two charts, one including all performance measures, and one not including baseline and discontinued measures. While 70 percent of targets were exceeded, met or improved based on all measures, 88 percent of targets were exceeded, met or improved based on measures that were not base-lined or discontinued.

### Actual and Target Performance Trends

Trends in actual performance and targets have been analyzed since 2004 where data was available. Trends can move upward, downward, or remain flat. Depending on the type of measure, a trend can be favorable, unfavorable, or remain unchanged. Results indicate that 63 percent of actual performance trends were favorable, 31 percent were unfavorable, and 6 percent were unchanged. Target trends were 53 percent favorable, 29 percent unfavorable, and 18 percent unchanged.

### Treasury Cost per Person

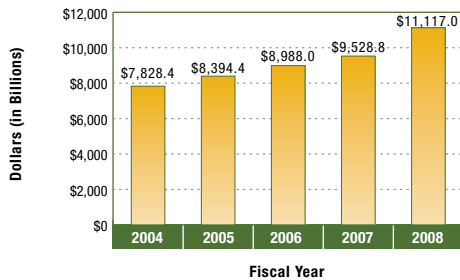
A chart that indicates the approximate cost of the Treasury Department per person in the United States is shown here. The calculation is determined by dividing Treasury Performance Cost by an estimate of the U.S. population at the end of fiscal year 2008. This ratio attempts to describe the cost of the Department in terms people can relate to.

### Treasury Performance and Cost versus Inflation

A dual scale chart provides Treasury performance to target, performance cost, and inflation information since fiscal year 2004. The data indicate that the gap between Treasury Performance Cost and inflation is narrowing while performance has improved.

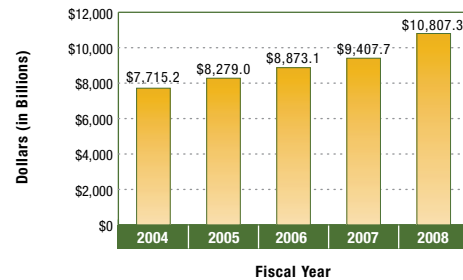
# FINANCIAL HIGHLIGHTS

### Total Assets (in Billions)



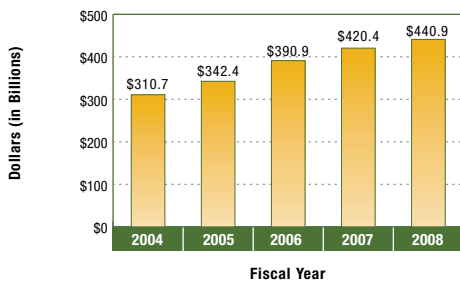
The increase of \$1.6 trillion in total assets in fiscal year 2008 is largely due to the increase in future funds required from the General Fund of the U.S. Government to pay for the federal debt owed to the public and other federal agencies.

### Total Liabilities (in Billions)



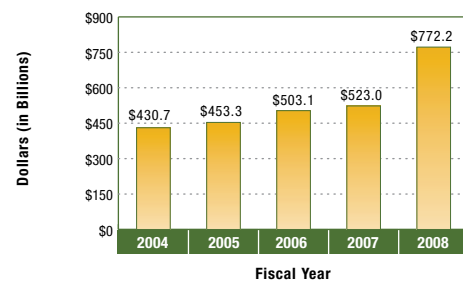
Total liabilities increased by \$1.4 trillion from fiscal year 2007 to fiscal year 2008. The majority of the increase is due to borrowings from other federal agencies and debt issued to the public.

### Net Federal Debt Interest Costs (in Billions)



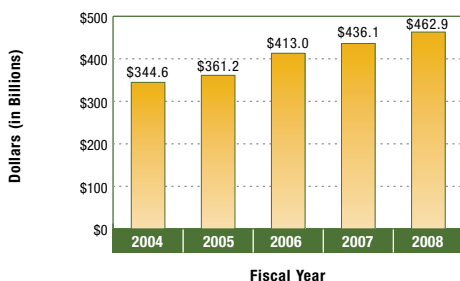
The increase of \$20.5 billion in net interest paid on the federal debt is due to the increase in the debt. Total federal debt and interest payable increased by \$1.05 trillion in fiscal year 2008.

### Total Budgetary Resources (in Billions)



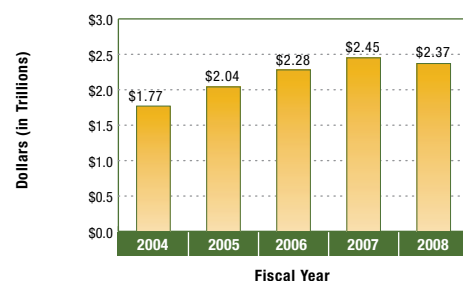
The majority of the increase in total budgetary resources for fiscal year 2008 was to ensure liquidity of Government-Sponsored Enterprises (GSEs) pursuant to the *Housing and Economic Recovery Act of 2008*.

### Net Outlays (in Billions)



The majority of the \$26.8 billion increase in net outlays was due to the increase in interest payments on the federal debt.

### Net Custodial Revenue Received (in Trillions)



Total custodial revenue collected on behalf of the U.S. Government decreased by \$82 billion. The majority of the decrease can be attributed to the Economic Stimulus payments of \$93.4 billion issued by the Internal Revenue Service.

# FISCAL YEAR 2008 KEY INITIATIVES

## LED GOVERNMENT RESPONSE TO FINANCIAL MARKET CHALLENGES

Throughout fiscal year 2008, the Treasury Department coordinated with federal agencies, state authorities, international bodies and private groups to address challenges in financial markets and the broader economy. Some examples include:

- Coordinated government mortgage management initiatives with the Department of Housing and Urban Development (HUD)
- Developed funding solutions for economically distressed industries with the Department of Commerce
- Developed alternative funding solutions for student loan programs with the Department of Education
- Coordinated international financial negotiations with the Department of State
- Collaborated with the Financial Stability Forum (FSF), a body consisting of representatives from the world's largest economies and international financial institutions, and G-7 countries to develop international guidelines for managing financial market challenges
- Worked with various state authorities to address mortgage origination issues and concerns about conditions at state-chartered financial institutions

For financial market management in particular, the Department worked with members of the President's Working Group on Financial Markets (PWG), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA) and other agencies to respond to market events.

Established in 1988, the PWG is the federal government's primary inter-agency committee responsible for coordinating supervision of financial markets and is comprised of:

- The Secretary of the Treasury, who serves as Chairman

- The Chairman of the Board of Governors of the Federal Reserve
- The Chairman of the Securities and Exchange Commission (SEC)
- The Chairman of the Commodities Futures Trading Commission (CFTC)

In August 2007, the President charged the PWG with reviewing the underlying causes of financial market turmoil. In response, the PWG issued a *Policy Statement on Financial Market Developments* in March 2008 providing both an overview of causes as well as specific policy recommendations to address regulatory and management shortfalls. The key recommendations to government authorities and market participants to address market weaknesses include:

- Reforming key parts of the mortgage origination process in the U.S.
- Enhancing disclosure and improving the practices of sponsors, underwriters, and investors with respect to securitized credits
- Reforming the credit rating agencies' processes for and practices regarding rating structured credit products
- Ensuring that global financial institutions take appropriate steps to address weaknesses in risk management and reporting practices
- Ensuring that prudential regulatory policies applicable to banks and securities firms, including capital and disclosure requirements, provide strong incentives for effective risk management practices

The report includes 27 specific recommendations for public and private sector action within these broad categories.

The PWG issued a detailed report on progress in October 2008 and is continuing to monitor the implementation of recommendations.

The Treasury Department, as the nation's foremost economic policy agency, will continue to take necessary steps to address financial market challenges in coordination with public and private sector agencies.

## DEVELOPED AND IMPLEMENTED THE ECONOMIC STIMULUS ACT OF 2008

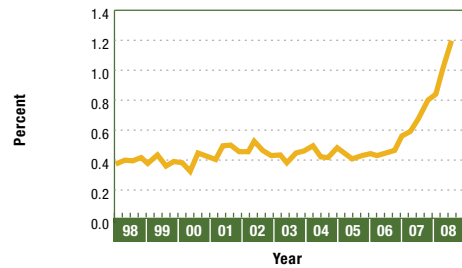
The *Economic Stimulus Act of 2008* was signed into law on February 13, 2008. Created to support the economy during a period of slowing growth, the bill provided relief in the form of individual tax rebates for households and tax incentives for businesses to stimulate investment. Businesses were expected to utilize \$45 billion in tax deductions by the end of 2008. In fiscal year 2008, over 116.2 million stimulus payments, totaling \$94.3 billion, were issued in the form of checks and electronic deposits.

The Department participated directly in development and implementation of the stimulus package. The IRS and FMS managed customer inquiries and issued payments during the tax season. In particular, the IRS provided informational announcements and mailings, interactive telephone options, an online payment calculator, and maintained a hotline to allow taxpayers to check on the status of their payment. The FMS issued 74.1 million paper checks and made over 42 million electronic deposits. Some additional statistics on the stimulus payments:

- The first stimulus payments were made by electronic deposit 75 days after the legislation was passed
- A total of 132.9 million notices were sent to inform taxpayers of their potential eligibility
- 5.5 million operator-assisted calls and 21.9 million automated calls were handled, resulting in a 90 percent increase in total telephone demand
- 38.7 million taxpayers used the “*Where’s My Stimulus Payment?*” webpage to check the status of their payment
- \$1.46 billion in delinquent non-tax, state tax, and child support debts were withheld from stimulus payments and disbursed to appropriate recipients

Additional information may be found here: [Stimulus Payment](#)

Mortgage Foreclosures Started as a Percent of All Loans, Quarterly



Source: Mortgage Bankers Association

## SUPPORTED THE HOPE NOW ALLIANCE

Ongoing challenges in housing markets have increased pressure on homeowners unable to make their mortgage payments. Seeking to support a coordinated response to the crisis, the Department participated in discussions with mortgage industry participants in August 2007 to search for a solution to address market conditions. The result was the formation in October 2007 of the HOPE NOW Alliance, a private sector alliance of mortgage servicers, counselors, and investors to provide information and direct assistance to homeowners to help avoid preventable foreclosures.

HOPE NOW has worked aggressively over the past year to disseminate information to at-risk homeowners through direct mailings, advertisements, and phone contacts. They have also actively coordinated matching at-risk homeowners with mortgage industry specialists to find best solutions. In December 2007, HOPE NOW adopted the mortgage management framework developed by the American Securitization Forum, and in February 2008 adopted Project Lifeline to focus efforts as efficiently as possible to help at-risk homeowners. As of August 2008, HOPE NOW included 94 percent of mortgage servicers and had helped over two million homeowners negotiate arrangements enabling them to avoid foreclosure and keep their homes.

The success of the HOPE NOW Alliance is encouraging in light of the ongoing difficulties in mortgage markets.

The Treasury Department will continue to work closely with lenders and key industry participants to identify aggressive strategies to help at-risk homeowners.

Additional information may be found here: [HOPE NOW](#)

## SOLUTIONS FOR NON-DEPOSITORY INSTITUTIONS

Working in coordination with the Federal Reserve and SEC, Treasury participated in negotiations during fiscal year 2008 to determine an appropriate course to address financial difficulties at some of the country's largest non-depository financial institutions. Challenging conditions in financial markets, particularly linked to rapidly falling values of Mortgage Backed Securities or MBS (securities issued with mortgages as collateral), asset-backed commercial paper (short-term securities generally linked to revenue streams, such as payments of auto loans or credit cards), credit default swaps (similar to insurance policies on debt in case of default) and other instruments increased financial pressures on institutions with large holdings of these assets. Failure of a few large institutions with significant market presence threatened to severely impact market confidence. To ensure confidence in capital markets, extraordinary consultations and actions were taken to address conditions in financial institutions such as Bear Stearns, Lehman Brothers, and American International Group. The Department will continue to monitor financial conditions and respond as necessary to maintain the health of the financial system.

## CONTRIBUTED TO PLACEMENT OF FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP

On July 30th 2008, President Bush signed the *Housing and Economic Recovery Act of 2008* into law, granting the Treasury Department, the Federal Reserve and the new Federal Housing Finance Agency (FHFA) authority to enhance stability in financial markets and manage affairs related to the two largest sources of mortgage finance, the Federal National Mortgage Association (Fannie Mae) and

the Federal Home Loan Mortgage Corporation (Freddie Mac). Among the new authorities given to the FHFA was the ability to bring the two government-sponsored enterprises (GSEs) under either conservatorship (allowing FHFA to assume the powers of the GSEs' directors, officers, and shareholders without declaring bankruptcy) or receivership (allowing FHFA to assume the powers above and initiate liquidation). The Act also granted the Secretary of the Treasury temporary authority to purchase GSE obligations and securities through December 31, 2009.

Following passage of the legislation, financial markets, business conditions, and the current financial condition of the two GSEs were closely monitored. On September 7, 2008 the Treasury Department, Federal Reserve, and FHFA deemed it necessary for the preservation of market stability and taxpayer interests to place Fannie Mae and Freddie Mac in conservatorship under the July 2008 Act.

From the beginning of the current financial turmoil, the Treasury Department has maintained three critical objectives: provide stability to financial markets, support the availability of mortgage finance, and protect taxpayers. The intent of placing the GSEs under conservatorship was to minimize the near-term costs of insolvency at the two institutions and initiate resolution of systemic risks associated with the GSEs' structure. The steps taken were the result of detailed and thorough collaboration between FHFA, Treasury, and the Federal Reserve.

The Preferred Stock Purchase Agreements reached between Treasury and the two GSEs included the following provisions:

- For each GSE, the Treasury Department received \$1 billion in Senior Preferred Equity Shares, providing an annual dividend of 10 percent and permitting the Department to receive dividends before all other shareholders
- The Treasury received warrants (ownership options) for 79.9 percent of each enterprise
- The Department committed to provide each GSE up to \$100 billion under a secured lending facility to ensure solvency

- The Department committed to purchase up to \$5 billion in MBS issued by the GSEs

Fannie Mae and Freddie Mac's continued activity is central to recovery in the housing market and mitigation of underlying financial market uncertainty. The temporary liquidity and capital backstops included in the conservatorship arrangements are aimed at providing longer-term clarity to investors in GSE debt and MBS and ensuring the stability of financial markets. Fannie Mae and Freddie Mac continue to play an important role in financing mortgages in capital markets.

## PROPOSED LEGISLATION ALLOWING TREASURY TO INCREASE LIQUIDITY IN FINANCIAL MARKETS

On September 19, 2008, the Treasury Secretary, Federal Reserve Chairman, and SEC Chairman met with Congressional leaders to discuss legislation permitting Treasury to increase liquidity in financial markets by purchasing up to \$700 billion in assets from financial institutions. The initiative was primarily intended to ensure stability in financial markets and improve financial institutions' capital position to encourage new lending. On the same day, the Department also announced expansion of the existing program to purchase GSE MBS.

The *Emergency Economic Stabilization Act of 2008* was signed into law on October 3, 2008. The legislation included provisions for an expanded MBS purchase program, a whole loan purchase program, a troubled-assets insurance program, and an equity purchase program. Under the Act, Treasury was provided authority to purchase up to \$250 billion in securities, with an additional \$100 billion available upon written certification to Congress by the President and a final \$350 billion available upon written request by the President, subject to disapproval by Congress. The law provides a series of safeguards to protect taxpayer interests, including the establishment of two oversight boards and a Special Inspector General; requirements that participants provide the government an ownership stake in their business and restrict certain

payments to their executives; and strict provisions on asset manager selection.

## IMPLEMENTED MEASURES TO BOLSTER REGULATION OF NATIONAL BANKS AND THRIFTS

The OCC and OTS are the primary regulators of national banks and thrifts, respectively. With elevated concerns about banking solvency given strained financial markets, both have made extensive efforts to monitor evolving conditions at the financial institutions they regulate and implement measures to ensure the stability of the banking system. The Inspector General has indicated regulation of national banks and thrifts as a *Management Challenge* for fiscal year 2008.

In fiscal year 2008, 14 financial institutions with \$216 billion in deposits were placed into receivership under FDIC authority. Of these, five were national banks, three were thrifts, and six were state banks. The bulk of deposits were held by two thrifts, Washington Mutual Bank and IndyMac Bank, which accounted together for \$207 billion in deposits. Work-out solutions, whereby some or all deposits and assets were assumed by another existing bank, were arranged by FDIC and regulators for all failed institutions except IndyMac Bank. IndyMac Bank was placed under conservatorship and operations were assumed directly by FDIC under a newly-formed IndyMac Federal Bank.

Supervisory activities at OCC and OTS during fiscal year 2008 centered on evaluation of loan holdings and risk management practices to identify existing and potential weaknesses. In response to the crisis, supervisory efforts have been strengthened in key risk areas, including: underwriting and credit administration, diversification of funding sources (including realistic contingency funding planning), development of strong internal controls and risk management systems, timely recognition of losses, and maintenance of strong capital positions. Over the past year, resident examiner teams from the OCC have been in place at the largest national banks to monitor their funding, trading, and mortgage practices as well as gather information on market conditions, deal flow, and funding availability.

Information obtained by the examiners contributed to early identification of problem areas and development of risk management practices that have been implemented by the PWG, the Senior Supervisors Group, and the FSF. (The Senior Supervisors Group consists of supervisory agencies from France, Germany, Switzerland, Britain, and the U.S.)

Given increases in leveraged lending at national banks in prior years, the OCC undertook in-depth leveraged lending reviews at the largest national banks in fiscal year 2008, looking specifically at banks' syndicated pipeline management, stress testing, and limit setting. Following the reviews, a *Leveraged Lending* handbook was developed based on findings and issued to all banks, consolidating and supplementing guidance to bankers and examiners on managing leverage risk. At an inter-agency level, both the OCC and OTS have worked directly with the Federal Reserve and FDIC to review large syndicated loans through the Shared National Credit program. The comprehensive review in 2008 of these loans covered 8,750 credit facilities with commitments of over \$2.8 trillion. The OCC and OTS will continue to coordinate their licensing and supervisory procedures with other federal agencies to keep regulations current, transparent, and supportive of financial industry stability and growth.

Due to the thrift industry's natural concentration in longer-term mortgages (thrifts are required to keep 65 percent of their holdings in mortgages), the OTS maintains a Net Portfolio Value model which provides estimates of each institution's interest rate risk. The model allows the OTS to value a wide range of financial instruments and produce reports focusing on areas such as net interest income, liquidity, and value-at-risk. Enhancements to the Net Portfolio Value model were added in 2008 which improve examiners' ability to track interest rate risk and permit for easier electronic filing (E-Filing) of applications for actions requiring OTS approval.

To facilitate management of mortgage concerns, the OCC and OTS have encouraged banks and thrifts to work constructively with borrowers facing difficulty meeting their mortgage obligations. This includes support for industry initiatives such as the HOPE NOW alliance and

the American Securitization Forum as well as outreach efforts with advocacy groups, research organizations, community development practitioners, and community development membership organizations. During fiscal year 2008, the OCC published guides for homeowners on ways to recognize and avoid foreclosure rescue fraud and effectively manage certain hybrid adjustable rate mortgages. The OTS has issued additional guidance to thrifts governing regulation of late charges, prepayment penalties, and adjustments to mortgage terms. Given the high concentration of mortgage holdings at thrifts, the OTS has actively encouraged utilization of foreclosure-prevention strategies, including loan modifications, conversion of adjustable-rate mortgages into fixed-rate mortgages, extension of amortization, and payment deferral.

Although national banks were not dominant originators of subprime mortgages, strains in housing markets have significantly affected banks' residential mortgage and home equity loan portfolios. In response, the OCC began requiring the nine largest national bank servicers, accounting for 90 percent of mortgages held by national banks and 40 percent of mortgages overall, to submit comprehensive mortgage data on a monthly basis. Similarly, in July 2008 the OTS published its first *Mortgage Metrics Report*, presenting key performance data on first lien residential mortgages serviced by the top five thrifts or their affiliates, covering 91 percent of thrift mortgages. The data showed a total of 49,044 loss mitigation actions through the end of March, providing solutions for 25 percent of thrift loans in foreclosure. In September, the two supervisors merged their reports into a single *Mortgage Metrics Report*, covering some 35 million mortgages worth \$6.1 trillion, constituting an important data source on conditions in mortgage markets.

Given more stringent regulation and the conditions in mortgage markets, additional concern has more recently been directed towards the under-provision of credit in financial markets. The 2008 OCC *Annual Survey of Credit Underwriting Practices* showed that banks have substantially tightened underwriting standards for both retail and commercial loans over the last year. Regulatory guidance issued to banks and thrifts by both OCC and OTS has

reiterated the importance of maintaining prudent credit underwriting standards throughout the economic cycle.

## ESTABLISHED A TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS

On September 19, Treasury announced a Temporary Guarantee Program for money market funds. Taxable and tax-exempt funds regulated by the SEC under the *Investment Company Act of 1940* are eligible to participate in the guarantee program upon payment of an assessed fee of 0.01 percent of net asset value per share greater than or equal to \$0.9975 as of September 19. Funds with net asset value per share less than \$0.9975 and greater than or equal to \$0.995 are required to pay an upfront fee of 0.015 percent, based on the number of shares outstanding as of September 19. Funds with net asset values below \$0.995 were not eligible to participate. In return for participation, fund shareholders receive a guarantee that they will be compensated up to the \$1 share price of the fund should the share price fall below \$0.995. Initial funding of \$50 billion for the program was provided through the Exchange Stabilization Fund established under the *Gold Reserve Act of 1934*.

The Temporary Guarantee Program is a temporary measure intended to address short-term dislocations in credit markets. The program will exist for an initial three month term, after which the Secretary of the Treasury will review the need and terms for program extension. The Secretary has the option to renew the program through September 18, 2009. The program will not automatically extend for the full year and money market funds would be required to renew their participation to maintain coverage. If the Secretary does not renew the program at the end of the three month period, the program will terminate.

## RELEASED THE *BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE*

Recent capital market developments stemming from the subprime mortgage and credit turmoil have exposed the need for fundamental reform of the U.S. financial regulatory system. Created over 70 years ago, the U.S. financial regulatory structure today is managed under segregated industry “silos” that have failed to keep pace with industry changes. Under this structure, regulators have narrow responsibilities to supervise activities within their industry but little responsibility to regulate across industries. With the development of more integrated financial markets that are characterized by convergence of industries, interconnectedness, and globalization, this “siloed” structure has permitted substantial gaps and redundancies in oversight. To respond to these conditions, the Department issued a *Blueprint for a Modernized Financial Regulatory Structure* in March 2008 to identify and propose solutions to address major shortfalls in regulatory systems. The *Blueprint* provides a series of near, intermediate, and long-term recommendations to restructure the U.S. financial regulatory system.

### *Near-term recommendations:*

- Modernize the PWG by expanding its membership to include the heads of the OCC, OTS, and FDIC, enabling the body to serve as coordinator of financial regulatory policy for the entire financial industry
- Establish a federal Mortgage Origination Commission to develop national standards for mortgage origination and work to ensure compliance by all mortgage originators
- Improve Federal Reserve liquidity provisions with respect to non-depository financial institutions

### *Intermediate-term recommendations:*

- Transition financial institutions chartered as thrifts into national bank charters and merge the OTS into the OCC

- Establish one federal regulator of state banks, in contrast to the dual supervisory system splitting regulatory responsibility between the Federal Reserve and FDIC
- Establish a federal charter for payment and settlement systems supervised by the Federal Reserve
- Establish a federal charter and oversight board for insurance companies, distinct from state insurance licensing
- Merge the CFTC with the SEC, while retaining key strengths of each institution

### *Long-term recommendations*

- Restructure the existing financial regulatory system into a three-tiered system with duties divided by objectives, including:
  - A market stability regulator, likely the Federal Reserve, which would supervise overall conditions in financial markets and develop measures to address high-level market stability
  - A prudential financial regulator, which would be responsible for assessing risk management at all financial institutions and supervising institutions' safety and soundness associated with government guarantees
  - A business conduct regulator, which would establish standards for business practices for financial institutions and ensure protection of consumer rights
- In addition to these agencies, two other regulatory bodies were proposed:
  - A federal insurance guarantor, which would provide insurance services for the entire financial sector, similar to services currently provided to banks by the FDIC
  - A corporate finance regulator, which would oversee corporate finance in public securities markets, similar to services currently provided by the SEC

No amount of regulation can fully eliminate capital market risks, but it is clear that a modernized regulatory structure is essential to establishing a more stable financial system,

protecting consumer interests, and promoting financial market competitiveness.

Additional information may be found here: [\*Blueprint for a Modernized Financial Regulatory Structure\*](#)

## PARTICIPATED IN FEDERAL HOUSING ADMINISTRATION MODERNIZATION AND PROVISION OF TEMPORARY TAX RELIEF FOR HOMEOWNERS

In addition to GSE reform, two other presidential initiatives were announced in August 2007 to address problems in mortgage markets: expanding the capacity of the Federal Housing Administration (FHA) to provide mortgage assistance to a greater range of homeowners and providing temporary tax relief for homeowners entering foreclosure or negotiating partial mortgage write-downs.

The Department worked closely with HUD to promote passage of FHA-related statutes in the *Housing and Economic Recovery Act of 2008*. Among other provisions, the legislation expanded FHA's authority to provide assistance to homeowners by offering government insurance to lenders who voluntarily reduce mortgages for at-risk homeowners to at least 90 percent of the property's current value. (Also known as the Hope for Homeowners program.) To participate in the program, homeowners are required to share a portion of the appreciation of the value of their homes with the FHA. A board consisting of the Secretary of HUD, the Secretary of the Treasury, the Chairman of the Federal Reserve, and the Chairman of FDIC was established under the legislation to oversee implementation of the program. The new measures, which came into effect on October 1, 2008, are expected to help an additional 400,000 homeowners refinance into more affordable mortgages.

In addition to the Hope for Homeowners program, the FHASecure program has helped approximately 360,000 homeowners since July 2007 refinance into FHA-insured loans. The program provides assistance to homeowners with conforming loans (prime loans valued up to \$417,000) who are unable to afford mortgage payments

after the reset of their adjustable rate mortgage. Starting in July 2008, FHASecure also began providing assistance to subprime borrowers with adjustable rate mortgages who have missed up to three monthly mortgage payments over the previous 12 months or experienced temporary economic hardship. The Department was directly involved in promoting FHASecure and supported the extension of benefits to additional homeowners.

In December 2007, the *Mortgage Forgiveness Debt Relief Act of 2007* was passed providing temporary tax relief for homeowners entering foreclosure or negotiating partial mortgage write-downs. Generally, debt that is forgiven by a lender is included as income for tax purposes. The Act permits homeowners to refinance their mortgages and pay no federal taxes on forgiven debt if the refinance occurs during 2007, 2008, or 2009. An estimated \$200 million in tax forgiveness is projected to be available to homeowners under the legislation. The Treasury Department, through the IRS, OCC, and OTS, has encouraged homeowners with mortgage problems to take full advantage of the tax relief.

Additional information may be found here: [Mortgage Forgiveness Debt Relief Act](#)

## ISSUED THE *BEST PRACTICES FOR RESIDENTIAL COVERED BONDS*

The availability of affordable mortgage financing is essential to a healthy economy. Along with focusing on restoring the traditional sources of mortgage financing in 2008, the Treasury Department took steps to encourage development of new sources for mortgage funding and strengthen financial institutions by issuing a *Best Practices for Residential Covered Bonds*. In preparing this guidance, the Department consulted with European counterparts as well as the FDIC, Federal Reserve, OCC, OTS, SEC, and various market participants.

Covered bonds provide a means for issuing commercial banks or thrifts to sell off rights to mortgage payments made by borrowers without selling the mortgages themselves. In current practice, a large percentage of mortgages

are originated by banks or thrifts and then sold to an entity which creates MBS which are then sold to investors. In these transactions, ownership of the mortgage is effectively transferred from the mortgage originator to the bond holder and the mortgage originator has no liability if the mortgage is not paid. With covered bonds, the originator of the mortgage is required to place the mortgages on its books, making them liable for payments if the mortgage borrower does not pay. Additionally, as the mortgage remains on the originator's books, the originator is also required to keep capital reserves covering the mortgages. Covered bonds are currently used to finance mortgages in the United Kingdom and Europe, constituting a \$3.3 trillion market, and are a promising source of mortgage financing to complement the existing system in the U.S.

On July 15, 2008, the FDIC issued the *Final Covered Bond Policy Statement* which specified actions that the FDIC will take if a covered bond issuer becomes insolvent or is placed into receivership. The *Best Practices for Residential Covered Bonds* is a complement to the FDIC statement by introducing quality standards in areas such as collateral and disclosure. In conjunction with the release of the guidance, the Treasury Department updated its policy to include covered bonds as an approved asset category for Treasury's investments and deposits of public money with commercial counterparties, which will provide credibility for the asset class.

The \$11 trillion U.S. mortgage market can benefit from all forms of mortgage finance. As Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards, and strengthen financial institutions' balance sheets, covered bonds can help provide additional funding to homeowners and strengthen U.S. financial institutions by diversifying risk. America's four largest banks, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo, have announced plans to establish covered bond programs to launch the market in the United States.

Additional information may be found here: [Best Practices for Residential Covered Bonds](#)

## U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE

Initiated in 2006, the U.S.-China SED is a semiannual forum bringing together the two countries' highest-level officials to discuss key economic issues. The intent is to improve officials' understanding of the interests and challenges faced by their counterparts on issues of relevance to both economies, to improve policy coordination on areas of mutual interest, and to institutionalize a forum for addressing sensitive issues. Since its inception, the U.S.-China SED has held four full meetings with discussions on issues including management of financial and macroeconomic cycles, market access, trade, property rights protection, food and product quality, financial regulation, energy management, environmental policy, and other issues. The latest U.S.-China SED was held in Annapolis, Maryland in June 2008.

As the coordinator for the U.S. Government, the Department of the Treasury has worked closely with other agencies in the federal government to develop meeting agendas, establish policy goals, and facilitate implementation of final agreements. Key achievements during the December 2007 and June 2008 meetings included:

- Launching negotiations for a bilateral investment treaty to help open new opportunities for U.S. and Chinese investors

- Signing of a Ten-Year Energy and Environment Cooperation Framework focused on creating a new energy-efficient model for sustainable economic development
- Reaching agreements to further open financial markets in the areas of banking, insurance, and securities
- Expanding coordination on management of product quality and food safety
- Expanding efforts to address economic imbalances related to trade, investment, and exchange rates
- Establishing guidelines to improve transparency in administrative rule-making and innovation policy

By establishing this dialogue, both sides have committed to addressing potentially sensitive economic issues of interest in a central forum. Through the U.S.-China SED, the two countries' officials have reached important policy decisions and established relationships building mutual trust and promoting improved coordination. The fifth U.S.-China SED is scheduled to be held in Beijing, China in December 2008.

Additional information may be found here: [U.S.-China SED](#)

# FISCAL YEAR 2008 PERFORMANCE BY STRATEGIC GOAL

## EFFECTIVELY MANAGED U.S. GOVERNMENT FINANCES

### Tax returns filed electronically

In fiscal year 2008, a total of 98.5 million tax returns were filed electronically, a 10 percent increase over 2007. Although the Department has not yet reached the Congressional goal of having 80 percent of tax returns filed electronically, in fiscal year 2008 the Department achieved 63 percent for individual taxpayers including taxpayers who filed solely to claim the economic stimulus. Treasury continues to promote the use of the IRS Free File program as a means of increasing E-Filing. A recent survey showed that 96 percent of those who used the Free File program found it easy to use, 98 percent said that they would recommend it to others, and 95 percent said that they would use it again.

### Increase electronic payments

In fiscal year 2008, the Department issued 116.2 million economic stimulus payments. However, only 36.2 percent were made electronically. Overall, 79 percent of Treasury payments and associated information were made electronically. Treasury continues to promote the use of direct deposit for government payments through the Go Direct campaign. There were 901,054 conversions from paper checks to direct deposit during the third year of the campaign. This is an increase over the 510,045 conversions during the campaign's second year. The total number of conversions since the inception of the campaign is over 2.1 million for a return on investment of \$184.7 million.

### Debt financing

Debt financing operations are critical to ensuring that the government has the money needed to continue its operations. In fiscal year 2008, the Department conducted more than 200 auctions, resulting in the issuance of over \$5.6 trillion in marketable securities. Treasury successfully resumed the issuance of the 52-week bill on a monthly basis in order to meet increased demand for borrowing. Additionally, the minimum bid at Treasury

auctions was reduced from \$1,000 to \$100 to broaden the potential investor pool

### Saving bonds

Issuing savings bonds is an important aspect of debt financing and the Department is committed to offering them in an efficient manner. There are approximately \$700 billion in paper savings bonds outstanding. Going forward, Treasury is encouraging its customers to purchase and manage their holdings online using TreasuryDirect. TreasuryDirect allows customers to buy savings bonds and convert paper bonds to an electronic version, increasing efficiency in management and servicing of bonds over the long-term. To mitigate risks associated with online financial transactions, Treasury continually seeks ways to increase security. For example, TreasuryDirect Access Cards are distributed to account holders, providing a unique and secure means to access their accounts. While the website remains the primary means of communicating with the public about Treasury securities, outreach through other channels, such as financial literacy programs, will target customers unaccustomed to conducting transactions online. Although a date has not been set for the withdrawal of paper bonds from sale, the intent is to move investors to TreasuryDirect as the preferred way to buy and hold savings bonds.

### Need to address international tax issues

The Treasury Department is working to improve international tax administration to effectively deal with increased tax issues associated with globalization for both individual and corporate taxpayers. In fiscal year 2008, Treasury issued guidance addressing offshore and cross-border compliance risks. Collaboration with foreign tax administrators was expanded by the addition of Japan's National Tax Agency to the Joint International Tax Shelter Information Centre, an organization created by the tax agencies of the U.S., Britain, Canada, and Australia to identify and curb abusive cross-border transactions and schemes. The Treasury Department has tax representatives in ten international

cities, and in fiscal year 2009 tax representatives will be placed in Beijing, China.

### **Need to address high rates of erroneous payments**

The Department continues to have high rates of erroneous payments within the EITC program, however, improvements in 2008 allowed for removal of the long-standing EITC *Federal Managers' Financial Integrity Act of 1982* (FMFIA) Material Weakness. In fiscal year 2008, as part of the effort to complete the *Study of Universal Use of Advanced Payment of Earned Income Credit* mandated by Congress, Treasury took several steps to address the issue. These steps included improving communication with taxpayers and tax practitioners, reaching out to employers to gain their insights into the benefits, costs, risks, and barriers if the EITC program were expanded, and enhancing the training of examiners reviewing EITC returns. In fiscal year 2008, \$3.2 billion in revenue was protected through examination of returns claiming the EITC credit and document matching programs.

## **U.S. AND WORLD ECONOMIES PERFORM AT FULL ECONOMIC POTENTIAL**

### **Contributed to reforms at the IMF, World Bank, and other international institutions**

In fiscal year 2008, the Department was actively involved in reforms at international financial institutions. One of the more outstanding achievements was reform at the IMF. Based on the Department's recommendation, the IMF has restructured its voting system to expand participation for emerging market countries, coordinated development of investment guidelines for sovereign wealth funds, and undertaken management reorganization saving some \$100 million in annual expenses. With these changes, the IMF is redefining its role in international markets to better match global exchange and investment needs.

### **Banking regulators finalized U.S. Basel II rules**

In November 2007, federal banking regulators (the Federal Reserve, FDIC, OCC, and OTS) reached final agreement

on U.S. rules implementing the Basel II Capital Accord. The agencies issued a notice of proposed rulemaking in July 2008 and are expected to implement final rules in 2009. The new provisions effectively marry banks' internal risk management systems with their capital requirements, more directly linking asset risks with cash holdings. In addition to the standard Basel II rules, the proposed U.S. rules preserve two requirements from current U.S. regulations — a conforming leverage ratio and prompt corrective action requirements — to maintain consistency in supervisory quality. Implementation of the rules is required for the country's ten largest banks. Other banks are currently permitted to implement the new rules on an optional basis and will otherwise continue to be subject to previous capital requirement regulations.

### **Provided loans, investments, financial services, and technical support through the CDFI Fund**

The CDFI Fund provides capital, loans, and tax credits to specialized financial institutions that finance economic development in underserved communities. The Fund competitively awards amounts to organizations that offer a wide array of banking services, including loans, investments, and financial education to underserved populations and communities. The Fund also provides incentives for community development by allocating federal tax credits to organizations that attract investors for commercial, retail, industrial, and mixed-use development projects. These organizations sell these credits to investors, which can be applied against federal income taxes, in order to generate funds for projects in target markets. Investments associated with the CDFI Fund contributed to the creation or maintenance of 29,539 jobs in fiscal year 2008, surpassing the program target of 28,676 jobs.

### **Market conditions complicate efforts to mitigate risks at national banks and thrifts**

Current market conditions can be attributed in part to poor risk management practices at financial institutions and insufficient government regulation of lending activities. While the vast majority of national banks and thrifts remain well capitalized, there are some which remain over-exposed to riskier mortgage assets or highly leveraged

investments. Over the past year, the OCC and OTS have made pointed efforts to work with national banks and thrifts to reduce exposure to risky assets and improve risk management, as outlined previously in the *Key Initiatives* section. However, current strained markets for some products, and over-exposure by some institutions to softer regional markets, have complicated efforts to manage these risk exposures. Assets with uncertain valuations remain on financial institutions' books – removing them will require time and effective risk management. Deleveraging, as banks reduce holdings in certain assets, has also incurred substantial costs. Until these assets can be removed from institutions' balance sheets, new lending will remain constrained. The OCC and OTS will continue to work with national banks and thrifts to isolate risky investments and work towards developing strategies to limit exposure to future losses.

### **Incomplete regulatory restructuring of the financial system**

The current “siloe” system of regulatory oversight in the United States is incompatible with financial markets characterized by cross-sector convergence and market globalization. Many of the recent problems in financial markets have stemmed from a confusing and sometimes insufficient mix of state and federal financial regulations, lack of appreciation for the growing complexity of cross-sector financial transactions and institutions, and lack of understanding of the riskiness of certain investments. Issuing the *Blueprint for a Modernized Financial Regulatory Structure* in March 2008 capped the Department's analytical review of the financial system. Included in the report are a series of near, intermediate, and long-term measures to improve regulatory oversight and restructure the “siloe” system. Common across these measures is a recognized need to establish stronger federal oversight of mortgage origination, insurance practices, clearing operations, and banking regulation. These policy recommendations are outlined previously in the *Key Initiatives* section. As of the end of fiscal year 2008, most recommendations from the *Blueprint* had yet to be implemented.

### **Incomplete reforms of Medicare and Social Security**

The financial conditions of Medicare and Social Security remain dire. Based on actuarial assumptions published in March 2008, the Medicare Hospital Insurance trust fund is projected to begin paying out more in expenditures than it receives in taxes and dedicated revenues by the end of 2008. With the deficit between expenditures and revenue expected to continue rising, the fund is expected to be exhausted by 2019. Under current assumptions, Social Security is similarly projected to begin paying out more in benefits than it receives in income and payroll taxes in 2011, with the fund exhausted by 2041. The current actuarial deficit to cover all expected future payments for Social Security recipients is \$13.6 trillion. (The actuarial deficit is the required funding needed today to pay for the existing liabilities of all current contributors and recipients.) In addition, the Medicare Supplementary Medical Insurance program that covers prescription drug benefits is projected to require general revenue financing that will grow faster than the economy and beneficiary incomes. These budgetary shortfalls will require policy action to ensure the solvency of the two funds and manageable provision of prescription drug benefits. Given the Secretary's position as Chairman of the Boards of Trustees for the Social Security and Medicare trust funds, in fiscal year 2008 the Department issued five articles offering policy recommendations to address funding problems at the two funds. Government action on these recommendations, however, was limited during 2008, due to significant attention directed at immediate financial challenges.

### **Protectionist interests impede the ability to maintain open economies**

Preservation of open international trade and financial channels has become more challenging in today's economic environment. Collapse of the Doha Round talks in July 2008, heightened concerns about investments by sovereign wealth funds and foreign government-owned enterprises and delayed consideration of the U.S.-Colombia Free Trade Agreement highlight these challenges. The Treasury Department supports the expansion of trade and investment opportunities which can promote economic development and security. While the number of U.S. free

trade agreements negotiated with Treasury Department input increased in 2008, delayed implementation of these agreements has limited their benefit for the U.S. economy. The Department will continue to actively participate in the U.S. Government's efforts to open access to foreign markets and promote trade and investment growth.

### **Improve productivity management relating to the printing and engraving of currency notes**

The manufacturing of currency notes experienced a 0.6 billion unit (7.2 percent) reduction in quantity ordered by the Federal Reserve, a drop from 8.3 billion notes in 2007 to 7.7 billion in 2008. This reduction in the Federal Reserve order was large enough to affect a 12 percent drop in BEP's productivity between fiscal years 2007 and 2008.

### **Improve supply management for bullion coin production**

As the economy and financial markets softened, investors sought the perceived safety of precious metals. Revenue from the sale of gold, platinum, and silver bullion coins more than doubled, increasing to \$949 million in fiscal year 2008 from \$356 million in fiscal year 2007. However, successful sales efforts in the bullion product line posed a new set of challenges. The volume of precious metal blanks suppliers were able to provide on time and production capacity limits at the Mint constrained the number of bullion products that could be produced. These forces compelled the Mint to temporarily suspend sale of certain bullion coins as production was unable to meet demand.

### **Manage cost issues related to the penny and nickel**

For the third year in a row, the penny and nickel cost more to produce than their face value. Two primary factors affected the cost to produce these coins. First, the slowing economy reduced demand for circulating coins, increasing the fixed production cost per unit. Shipments from the Mint to the Federal Reserve fell from 15.4 billion coins in 2007 to 8.6 billion in 2008. Second, global price increases for copper, nickel, and zinc, the metals used to produce the penny and nickel, drove up per unit production costs. Between September 2004 and September 2008, spot prices for copper, nickel, and zinc increased by 141.5 percent, 34

percent, and 78 percent, respectively. The Department is working with Congress to determine more cost-effective ways to produce circulating coins in the future.

## **PREVENTED TERRORISM AND PROMOTED THE NATION'S SECURITY THROUGH STRENGTHENED INTERNATIONAL FINANCIAL SYSTEMS**

### **Persuaded a number of the world's leading financial institutions of the risks of dealing with Iran and Iranian banks**

A precautionary advisory and an online warning were issued to U.S. banks about the risks of doing business with Iran. Specific attention focused on the Central Bank of Iran which has engaged in deceptive financial conduct, including requesting that its name be removed from global transactions to make it more difficult for intermediary financial institutions to determine the true parties in the transaction. Simultaneously, Treasury continued to take targeted financial actions against Iranian individuals and entities engaged in Iran's proliferation activities or support to terrorist groups. Bank Melli, Iran's largest bank, was designated for providing services to entities involved in Iran's nuclear and ballistic missile programs, including entities listed by the United Nations for their involvement in those programs. Bank Mellat was designated for providing bank services in support of Iran's nuclear entities. A vast majority of the world's leading financial institutions have dramatically scaled back or completely cut off their dealings with Iran and its banks as a result of mutually reinforcing actions taken by government and private sector entities. These actions helped protect the integrity of the financial system from illicit conduct while supporting a multilateral effort to reach a negotiated solution on Iran's nuclear program.

### **Designated and blocked key Zimbabwe regime supporters**

In January 2008, OFAC designated two Zimbabwean entities and two individuals as part of an increased effort to pressure those who are aiding Robert Mugabe's efforts to cripple Zimbabwe. In July 2008, the President signed

a new Executive Order to expand sanctions against the Government of Zimbabwe and significantly enhanced OFAC's ability to designate additional individuals and entities. This included entities owned or controlled by the Government of Zimbabwe or an official of the Government, or those that have participated in human rights abuses. OFAC designated 17 entities including several working with their government in an unofficial capacity. Designations included one individual whose support for Robert Mugabe's regime contributed to the undermining of democratic processes and institutions in Zimbabwe.

### Completed actions against FARC

The *Foreign Narcotics Designation Kingpin Act* gives Treasury the authority to apply economic sanctions against foreign narcotics trafficking worldwide. In fiscal year 2008, Treasury designated 15 key commanders of FARC leadership, parts of the FARC's money laundering network, senior Venezuelan officials supporting the FARC, and members of the FARC's international committee. According to a federal indictment, FARC is responsible for 60 percent of the cocaine that is brought into the United States, and is directly involved with its production and distribution. Four successive actions throughout the year focused on disrupting FARC's money laundering operations through the international financial system. These actions are part of an ongoing U.S. Government effort under this Act to apply financial measures against foreign drug kingpins.

### Led efforts within the Financial Action Task Force (FATF)

Critical to Treasury's strategic goal of preventing terrorism and strengthening national security is identifying systemic vulnerabilities that terrorist and other criminals can exploit to finance their operations and interests. Treasury led or co-chaired several important working groups within the FATF that produced valuable guidance and reports for identifying and addressing these vulnerabilities in the international financial system, including Iran, Pakistan, Sao Tome and Principe, Turkmenistan, Uzbekistan, and the northern part of Cyprus. As a result, the FATF issued

public statements expressing concern and alerting jurisdictions worldwide to the risks arising from the deficiencies in those anti-money laundering/counter-terrorist financing (AML/CFT) regimes.

### Increased collaboration with Intelligence Community

Treasury enhanced its efforts to provide timely, accurate, actionable, and policy-relevant intelligence analysis on the financial underpinnings of threats to national security. This analysis took the form of tactical and strategic assessments to inform policymaking and support enforcement actions. The Department strengthened relationships with its Intelligence Community counterparts and other partners in fiscal year 2008 through exchanges and assignments at the working level. Treasury hosted representatives from the National Security Agency, the Defense Intelligence Agency, United States Central Command, and other key partners to improve coordination. Treasury liaison officers participate in rotations within the Intelligence Community in the United States and overseas.

### Implemented efforts to increase Bank Secrecy Act effectiveness and efficiency

Treasury placed additional emphasis on providing guidance and feedback to regulated industries, engaging specific financial institutions and industries to learn more about the practical implications of regulatory requirements, and providing additional feedback to industry. A proposal was announced to significantly simplify the requirements for depository institutions to exempt their eligible customers from Currency Transaction Reporting. In fiscal year 2008, the draft rule on Chapter 10 was published, an effort to overhaul Bank Secrecy Act regulations for inclusion in the new Code of Federal Regulations, to provide greater clarity in regulations and make it easier for industry to follow, as well as more intuitive and responsive to industry feedback. This simplified approach serves as an important factor of the Department's anti-money laundering mission by facilitating compliance by financial institutions. Additionally, the Department worked collaboratively with other federal banking agencies to assess different approaches to examinations that are commensurate with risk.

### **Need to fully implement AML/CFT laws in key countries**

As a leader and representative of the Financial Action Task Force (FATF), the Department is responsible for encouraging countries to comply with international AML/CFT standards. Using these standards to determine compliance, FATF assessed 37 countries in fiscal year 2008 and the Department served as an assessor to 12 of these mutual evaluations. Despite Treasury's work, there is still room for improvement in implementing these laws in key countries. In particular, Pakistan has passed an anti-money laundering law, but has yet to implement it. Additionally, many Gulf countries have yet to adequately protect against vulnerabilities from cash courier systems.

### **Need to implement a mechanism for validating performance results**

A composite performance measure was developed to rate the impact of activities related to the Department's efforts to prevent terrorism and safeguard U.S. and international financial systems. Determining this impact has proved to be extremely difficult; currently the only validation is from internal customers and the Department. An external validation process needs to be determined.

## **MANAGEMENT AND ORGANIZATIONAL EXCELLENCE**

### **Issued audit reports**

TIGTA conducted audits and investigations to ensure fair administration of the nation's tax system and accountability for more than \$2 trillion in tax revenue collected each year. The audits conducted identify high-risk issues and deficiencies related to the administration of programs and operations. These audits ensure that taxpayers are served appropriately and their rights adequately protected. In fiscal year 2008, TIGTA issued 179 audit reports, making recommendations to improve areas such as tax compliance, security maintenance, systems, and operations, resulting in \$2.4 billion in potential financial benefits.

### **Enhance security of information technology**

The Treasury Department strives to provide a secure information technology infrastructure. Treasury strengthened its networks by encrypting 99.8 percent of laptops, 99.7 percent of digital assistants, testing 98 percent of system contingency plans, certifying and accrediting 97 percent of systems, strengthening security policies, and implementing enhanced safeguards to reduce exposure to Internet-based threats. However, the Department did not meet its goal of 100 percent compliance with Security Configuration requirements.

The Department recognizes the importance of cyber security in fulfilling its mission. In fiscal year 2008, Treasury made significant progress in strengthening security configuration management, which was noted as a significant deficiency in fiscal year 2007. The Federal Information Security Management Act (FISMA) 2008 audit found no significant deficiencies in information security, and the Department's remaining material weakness in this area was formally closed.

### **Created the Privacy and Treasury Records office**

Treasury is committed to maintaining, collecting, using, and disseminating information necessary to carry out its mission. PTR was created to strengthen the Department's privacy program and records management. PTR will ensure that Treasury has a system in place to serve and inform the public, and strengthen the Department's compliance with privacy and disclosure requirements.

### **Developed human capital measures**

In fiscal year 2008, the Department developed two human capital performance measures. The first measure is designed to assess progress in developing a high-performance, talented, and diverse workforce; the second measure is designed to assess Treasury's standing as a highly desirable employer of choice.

### **Strengthen corporate leadership**

The Treasury Department has made a profound effort in 2008 to promote corporate governance. In addition to daily meetings of the senior leadership team, weekly bureau head meetings, and monthly Treasury-wide council meet-

ings, the Department has taken several actions to improve corporate management. An Executive Review Board was re-established for major IT capital investments to better engage department and bureau executive leadership in IT decision making.

The Human Capital Strategic Plan was revised, identifying the factors that will shape the future workforce environment of the agency, and the corporate strategies that are needed to meet these challenges. A corporate approach to procurement provided significant savings and improved governance, communication, and training across the agency. A prototype Treasury performance scorecard was developed for the financial outcomes described in the Department's strategic plan.

Corporate governance activities were consistently monitored and any gaps in the process were identified. These included strategic planning, financial management, asset management, information technology, risk management, human capital, procurement, performance management, privacy and records management, and emergency/continuity program management.

### Material Loss Reviews

OIG is mandated to conduct MLRs of any Treasury-regulated bank failures resulting in material losses greater than \$25 million or two percent of the institution's assets. An MLR examines the cause(s) of the failure, the supervision exercised over the institution, and recommendations regulators can consider to help prevent future failures. Also examined are indicators of fraud that may lead to the criminal or civil prosecution of the perpetrators. In fiscal year 2008, OIG completed one MLR of the NetBank failure and currently has five MLRs in progress.

### President's Management Agenda

The PMA is a management initiative instituted in 2001 to improve management practices across the federal government and transform it into a results-oriented, efficient, and citizen-centered enterprise. The PMA is used as a framework to strengthen Treasury's workforce, lower the cost of doing business through competition, improve financial performance, increase the use of information technology and E-Government capabilities, and integrate budget decisions with performance data. Fiscal year 2008 results were similar to fiscal year 2007. Progress steadily improved throughout the year in the areas of E-Government, Performance Improvement, and Human Capital. For additional information see the [Treasury website](#).

President's Management Agenda								
Initiative	Status				FY 2008 Progress			
	FY 2005	FY 2006	FY 2007	FY 2008	Q1	Q2	Q3	Q4
Human Capital	Y	G	G	G	G	G	G	G
Commercial Services	G	G	Y	Y	Y	Y	Y	Y
Financial Performance	R	R	Y	Y	Y	Y	G	G
E-Government	R	Y	Y	Y	G	G	G	G
Performance Improvement	Y	Y	Y	Y	G	G	G	G
Improper Payments	R	R	R	R	Y	Y	Y	Y
Credit Management	N/A	N/A	Y	Y	Y	G	G	G
<span style="color: green;">G</span> Green for Success <span style="color: orange;">Y</span> Yellow for Mixed Results <span style="color: red;">R</span> Red for Unsatisfactory								

# SUMMARY OF MANAGEMENT CHALLENGES AND HIGH-RISK AREAS

## TREASURY-WIDE MANAGEMENT CHALLENGES

Management Challenge	Importance	Progress	Status
<i>Management of Treasury's Authorities Related to Distressed Financial Markets</i>	Protection of the taxpayer from unnecessary risk associated with the implementation of the program	New	New
<i>Regulation of National Banks and Thrifts</i>	Prevent or better mitigate unsafe and unsound practices and protect the financial health of the banking industry	New	New
<i>Corporate Management</i>	Overall agency performance/improved value for the taxpayer	Reasonable	Adequate
<i>Management of Capital Investments</i>	Effective use of taxpayer funds for large capital investments	Significant	Meets Expectations
<i>Information Security</i>	Appropriate protection of electronic information and cyber assets	Significant	Meets Expectations
<i>Linking Resources to Results</i>	Resources that are focused on producing the best value for stakeholders	A cost accounting policy revision and changes to operations allowed removal of this challenge	Closed
<i>Anti-Money Laundering and Terrorist Financing/BSA Reporting</i>	U.S. and international financial systems that are safe	Reasonable	Meets Expectations

## IRS MANAGEMENT CHALLENGES

Management Challenge	Importance	Progress	Status
<i>Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems</i>	Improved taxpayer service and efficiency of operations	Reasonable	Meets Expectations
<i>Tax Compliance Initiatives</i>	Improved compliance and fairness in the application of the tax laws	Reasonable	Meets Expectations
<i>Security of the Internal Revenue Service</i>	Appropriate protection of financial, personal, and other information	Reasonable	Meets Expectations
<i>Providing Quality Taxpayer Service Operations</i>	Improved taxpayer service	Significant	Exceeds Expectations
<i>Human Capital</i>	Enables the IRS to achieve its mission	Significant	Exceeds Expectations
<i>Erroneous and Improper Payments</i>	Effective use of taxpayer funds	Reasonable	Adequate
<i>Taxpayer Protection and Rights</i>	Fairness in the application of the tax laws	Significant	Meets Expectations
<i>Processing Returns and Implementing Tax Law Changes During the Tax Filing Season</i>	Improved taxpayer service and efficiency of operations	Significant	Exceeds Expectations
<i>Using Performance and Financial Information for Program and Budget Decisions</i>	Resources that are focused on producing the best value for stakeholders	Significant	Exceeds Expectations

Click on any management challenge for additional information.

Progress Rating	Description
New	A new management challenge in fiscal year 2008
None	No progress was made on the management challenge
Marginal	Minimal progress was made on the management challenge compared to the prior year
Reasonable	Progress was made in addressing the management challenge, improving from the prior year
Significant	A large amount of progress was made compared to the prior year assessment

Status Rating	Description
New	A new management challenge in fiscal year 2008
Inadequate	Regardless of progress made in the fiscal year, the status of the management challenge remains incomplete and falls significantly short of expectations
Adequate	The current status of the management challenge is acceptable but falls slightly short of expectations set for the fiscal year
Meets Expectations	The current status of the management challenge meets expectations set for the fiscal year
Exceeds Expectations	The current status of the management challenge exceeds expectations set for the fiscal year
Closed	Actions taken resulted in the elimination of the management challenge

## HIGH RISK AREA UPDATE: ENFORCEMENT OF THE TAX LAWS

### Challenges/Actions

#### *Reduce the opportunity for evasion*

- Propose legislation changes targeted at information reporting, compliance by businesses, and strengthening tax administration.

#### *Target specific areas of noncompliance and improve voluntary compliance with extensive research.*

- In fiscal year 2008 compliance studies will be completed on S corporations and individuals; in fiscal year 2009 updates to the payment and filing compliance estimates of the tax gap will be completed.
- Research the effect of service and its relationship to taxpayer compliance. In addition, survey taxpayers to see the relationship between complexity, burden, and compliance to improve workload selection formulas and reduce the burden of unnecessary taxpayer contacts.
- Assess outreach and education awareness campaigns that target the EITC eligible and non-compliant population, and adjust as necessary to increase participation and improve compliance. In fiscal year 2008 significant achievements were made: 1) established diagnostic measures for compliance, outreach, and support, 2) developed full cost computation for EITC compliance activities, 3) increased protected revenue from the under-reporter program by 190 percent, 4) increased base compliance activities by 35 percent, 5) reduced the no-change rate on examination cases by 59 percent, 6) realized a return on investment in compliance activities of 12-to-1 for examinations and 67-to-1 for under-reporter cases. In fiscal year 2009, activities from the fourth year of the EITC Return Preparer Study will be completed and short-term outcomes will be analyzed, including penalties and accuracy of returns, and the effect of due diligence visits, education/compliance notices, and phone calls to first-time EITC preparers.

#### *Improve information technology through modernization.*

- Execute the following initiatives: In fiscal year 2008 and fiscal year 2009 the process to match information documents to information on a tax return and improved case selection and scoring will be reengineered. In fiscal year 2009 data storage facilities will be enhanced to improve the workload identification. In fiscal year 2009 automated lien delivery will be deployed. In fiscal year 2009 new and improved analytics will be developed that identify issues and select cases for all types of audits. By fiscal year 2009 features will be built and implemented for an electronic transmission capability for additional tax forms on Modernized electronic Filing (MeF). In fiscal year 2009 the Broker Compliance Initiative pilot will be used to identify and address tax schemes of individuals and businesses.

For additional information, click here: [Enforcement of Tax Laws](#)

## HIGH RISK AREA UPDATE: IRS BUSINESS SYSTEMS MODERNIZATION

**Problem:** The Business Systems Modernization (BSM) program is developing and delivering a number of modernized systems to replace the aging business and tax processing systems currently in use. This effort is highly complex and scheduled to be carried out over a number of years, ultimately creating a more efficient and effective IRS. Though the IRS experienced delays and cost overruns in the early years of the effort, improved practices and oversight are now contributing to better delivery of outcomes.

**Goal:** Meet all BSM project milestones within a cost and schedule variance of 10 percent of the initial estimate.

## Challenges/Actions

### *Fully implement all projects and programs for the Business Systems Modernization program.*

- Customer Account Data Engine (CADE) will hold over 200 million individual and business taxpayer's information that will provide flexibility to respond quickly to complex tax law and policy initiatives. Through mid-August 2008 CADE processed 30.5 million individual tax returns which is 21 percent of all individual tax returns filed. Each new release of CADE will expand the functionality CADE can process and thus increase the numbers of returns processed. Under current resource assumptions, IRS has a goal of processing over 90 percent of all returns through CADE by Fall 2012.
- Make similar progress on all other BSM projects: Accounts Management Services (AMS) applies applications that enable IRS employees and taxpayers to access, validate, and update taxpayer accounts on demand. Modernized E-File (MeF) will allow the IRS to store all tax return data in a modernized tax return database allowing all viewers to see an entire tax return online. Custodial Detail Database (CDDDB) provides detailed data to support revenue financial reporting. Revenue Accounting Control System (RACS) will reduce the risk of failure to sustain future clean IRS audit opinions, and streamline financial reporting.

For additional information, click here: [IRS BSM](#)

# ANALYSIS OF FINANCIAL STATEMENTS

*The complete financial statements and auditor's report are in part III of this report.*

## CONDENSED CONSOLIDATED BALANCE SHEETS (in Millions):

	2008	2007
Due From the General Fund	\$ 10,100,763	\$ 9,052,624
Other Intra-governmental Assets	551,115	322,255
Cash, Foreign Currency, and Other Monetary Assets	387,270	92,330
Gold and Silver Reserves	11,062	11,062
Investments and Related Interest	10,576	10,074
Tax, Other, and Related Interest Receivables, Net	30,878	27,559
Other Assets	25,374	12,903
<b>Total Assets</b>	<b>11,117,038</b>	<b>9,528,807</b>
Federal Debt and Interest Payable	10,075,108	9,029,038
Other Intra-governmental Liabilities	681,621	343,466
Other Liabilities	50,598	35,204
<b>Total Liabilities</b>	<b>10,807,327</b>	<b>9,407,708</b>
Unexpended Appropriations	271,968	72,317
Cumulative Results of Operations	37,743	48,782
<b>Total Net Position</b>	<b>309,711</b>	<b>121,099</b>
<b>Total Liabilities and Net Position</b>	<b>\$ 11,117,038</b>	<b>\$ 9,528,807</b>

## CONDENSED CONSOLIDATED STATEMENTS OF NET COST (in Millions):

	2008	2007
Net Financial Program Cost	\$ 12,287	\$ 11,735
Net Economic Program (Revenue)/Cost	248	(456)
Net Security Program Cost	342	300
Net Management Program Cost	466	440
<b>Total Net Cost of Treasury Operations</b>	<b>13,343</b>	<b>12,019</b>
GSE Costs	13,800	—
Net Federal Costs (primarily interest on the Federal Debt)	\$ 442,208	\$ 429,302

## CONDENSED STATEMENTS OF CUSTODIAL ACTIVITY (in Millions):

	2008	2007
Individual and FICA Taxes	\$ 2,294,326	\$ 2,201,464
Corporate Income Taxes	354,063	395,320
Other Revenues	144,218	142,005
<b>Total Revenue Received</b>	<b>2,792,607</b>	<b>2,738,789</b>
Less Refunds	(426,074)	(292,684)
<b>Net Revenue Received</b>	<b>2,366,533</b>	<b>2,446,105</b>
Accrual Adjustment	3,132	5,588
<b>Total Custodial Revenue</b>	<b>2,369,665</b>	<b>2,451,693</b>
Amounts Provided to Fund the Federal Government	2,366,126	2,445,619
Other	407	486
Accrual Adjustment	3,132	5,588
<b>Total Disposition of Custodial Revenue</b>	<b>2,369,665</b>	<b>2,451,693</b>
<b>Net Custodial Revenue Activity</b>	<b>\$ 0</b>	<b>\$ 0</b>

**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES  
IN NET POSITION** (in Millions):

	<b>2008</b>	<b>2007</b>
Beginning Balance	\$ 48,782	\$ 46,644
Budgetary Financing Sources	482,150	447,331
Other Financing Sources (Uses)	(23,838)	(3,872)
Total Financing Sources	458,312	443,459
Net Cost of Operations	(469,351)	(441,321)
Net Change	(11,039)	2,138
<b>Cumulative Results of Operations</b>	<b>37,743</b>	<b>48,782</b>
Beginning Balance	72,317	68,270
Appropriations Received	681,473	451,222
Appropriations Used	(481,735)	(447,057)
Other	(87)	(118)
Total Budgetary Financing Sources	199,651	4,047
<b>Total Unexpended Appropriations</b>	<b>271,968</b>	<b>72,317</b>
<b>Net Position - Year End</b>	<b>\$ 309,711</b>	<b>\$ 121,099</b>

**CONDENSED COMBINED STATEMENTS OF  
BUDGETARY RESOURCES** (in Millions):

	<b>2008</b>	<b>2007</b>
Unobligated Balance, Brought Forward	\$ 57,450	\$ 57,540
Recoveries of Prior Year Unpaid Obligations	413	474
Budget Authority	722,859	474,974
Other Budget Authority	(8,558)	(10,008)
<b>Total Budgetary Resources</b>	<b>772,164</b>	<b>522,980</b>
Obligations Incurred	487,534	465,530
Unobligated Balance	273,235	46,455
Unobligated Balance Not Available	11,395	10,995
<b>Total Status of Budgetary Resources</b>	<b>772,164</b>	<b>522,980</b>
Total Unpaid Obligated Balances, Net	57,393	52,448
Obligations Incurred, Net	487,534	465,530
Gross Outlays	(487,608)	(460,302)
Recoveries of Prior Year Unpaid Obligations, Actual	(413)	(474)
Changes in Uncollected Customer Payments Federal	71	191
<b>Total Unpaid Obligated Balance, Net, End of Year</b>	<b>56,977</b>	<b>57,393</b>
Gross Outlays	487,608	460,302
Offsetting Collections & Distributed Offsetting Receipts	(24,740)	(24,232)
<b>Net Outlays</b>	<b>\$ 462,868</b>	<b>\$ 436,070</b>

## AUDITOR'S REPORT ON THE TREASURY DEPARTMENT'S FINANCIAL STATEMENTS

The Department received an unqualified audit opinion on its fiscal year 2008 financial statements. The auditor reported a material weakness related to financial systems and reporting at the IRS and significant deficiencies related to financial management practices at the departmental level and controls over foreign currency transactions. The auditor also reported an instance of noncompliance with laws and regulations related to Section 6325 of the Internal Revenue Code and that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996. In addition, a potential Anti-deficiency Act violation related to transactions and activities of the Financial Crimes Enforcement Network was reported.

### Summary of Financial Statement Audit

Audit Opinion	Unqualified				
Restatement	No				
Material Weakness	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Financial Systems and Reporting at the IRS	1	0	0	0	1

### Limitations on the Principal Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Department of the Treasury, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of the Department of the Treasury, in accordance with GAAP for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

### Major Highlights

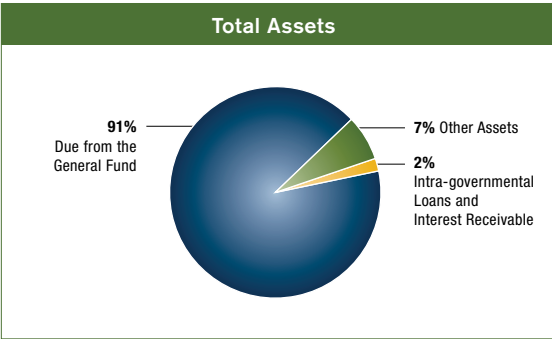
The following provides the highlights of Treasury's financial position and results of operations for fiscal year 2008.

MAJOR HIGHLIGHTS

The following provides the major highlights of Treasury’s financial position and results of operations for fiscal year 2008.

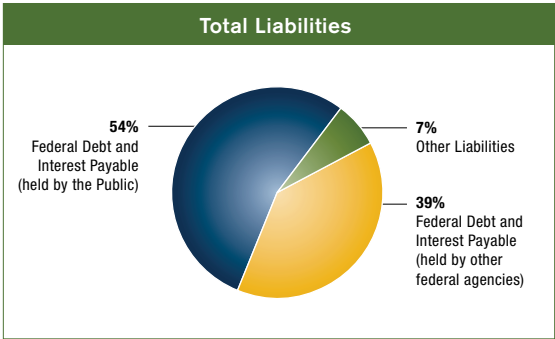
**Assets.** Total assets increased from \$9.5 trillion at September 30, 2007, to \$11.1 trillion at September 30, 2008. The primary reason for the increase is the rise in the federal debt, which causes a corresponding rise in the “Due from the General Fund of the U.S. Government” account (\$10.1 trillion). This account represents future funds required from the General Fund of the U.S. Government to pay borrowings from the public and other federal agencies.

The majority of loans and interest receivable (\$264.9 billion) included in “Intra-governmental” assets are the loans issued by the Bureau of the Public Debt to other federal agencies for their own use or to private sector borrowers, whose loans are guaranteed by the federal agencies.



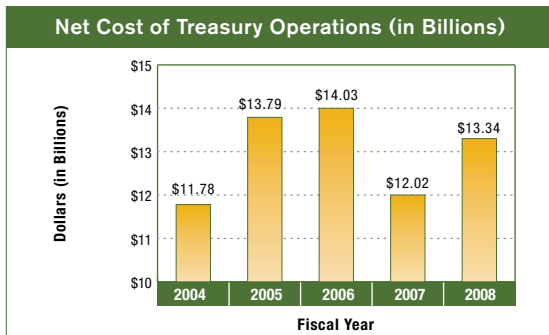
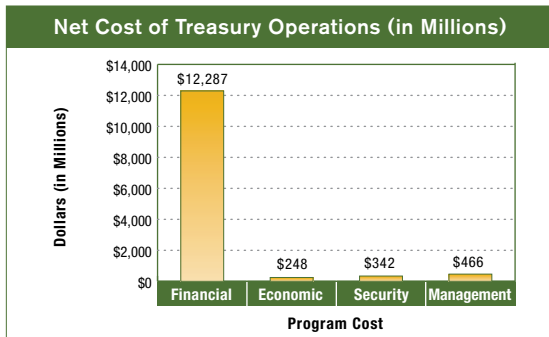
**Liabilities.** Intra-governmental liabilities totaled \$4.9 trillion, and include \$4.3 trillion of principal and interest payable to various federal agencies such as the Social Security Trust Fund.

Liabilities also include federal debt held by the public, including interest, of \$5.8 trillion; this debt was mainly issued as Treasury Notes. The increase in total liabilities in fiscal year 2008 over fiscal year 2007 (\$1.4 trillion and 14.9%) is the result of increases in borrowings from various federal agencies (\$257 billion), and federal debt held by the public, including interest (\$759.4 billion). Debt held by the public increased primarily because of the need to finance budget deficits.

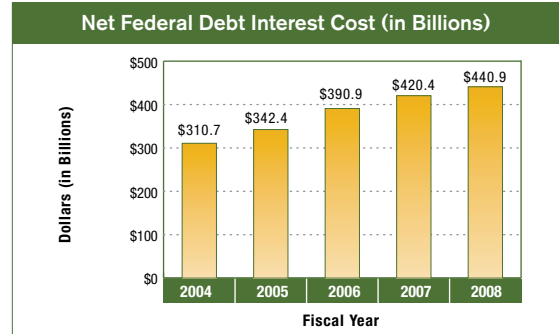


**Net Cost of Treasury Operations.** The Consolidated Statement of Net Cost presents the Department's gross and net cost for its four strategic missions: financial program, economic program, security program, and management program. The majority of the Net Cost of Treasury Operations is in the financial program. Treasury is the primary fiscal agent for the Federal Government in managing the nation's finances by collecting revenue, making federal payments, managing federal borrowing, performing central accounting functions, and producing coins and currency sufficient to meet demand.

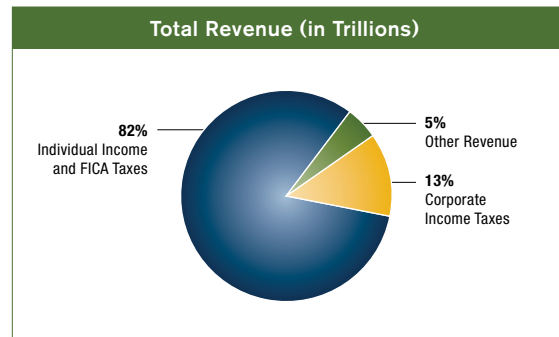
Net cost (not from Treasury operations) includes \$13.8 billion related to the GSE Keepwell agreement.



**Net Federal Debt Interest Costs.** Interest costs have increased over the past four years due to the increase in the federal debt.



**Custodial Revenue.** Total net revenue collected by Treasury on behalf of the Federal Government includes various taxes, primarily income taxes, user fees, fines and penalties, and other revenue. Over 94.8 percent of the revenues are from income and social security taxes.



# IMPROPER PAYMENTS INFORMATION ACT AND RECOVERY AUDITING ACT

## IMPROPER PAYMENTS INFORMATION ACT

### Background

The Improper Payments Information Act of 2002 (IPIA) requires agencies to review their programs and activities annually to identify those susceptible to significant improper payments. According to Office of Management and Budget (OMB) Circular A-123, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments* (A-123, Appendix C), “significant” means that an estimated error rate and a dollar amount exceed the threshold of 2.5 percent and \$10 million of total program funding. A-123, Appendix C also requires the agency to implement a corrective action plan that includes improper payment reduction and recovery targets.

However, some federal programs are so complex that developing an annual error rate is not feasible. The government-wide Chief Financial Officers Council developed an alternative for such programs to assist them in meeting the IPIA requirements. Agencies may establish an annual estimate for a high-risk component of a complex program (*e.g.*, a specific program population) with OMB approval. Agencies must also perform trend analyses to update the program’s baseline error rate in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

## Treasury’s Risk Assessment Methodology and Results for Fiscal Year 2008

Each year, Treasury develops a comprehensive inventory of all funding sources and conducts a risk assessment for improper payments on all of its programs and activities. The risk assessment performed on all of Treasury’s programs and activities resulted in low and medium risk susceptibility for improper payments except for the Internal Revenue Service’s (IRS) Earned Income Tax Credit (EITC) program. The high-risk status of this program is well-documented and has been deemed a complex program for the purposes of the IPIA.

### Earned Income Tax Credit

The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers and, if the credit exceeds the amount of taxes due, provides a lump-sum payment in the form of a refund to those who qualify. The fiscal year 2008 estimate is that a maximum of 28 percent (\$13.1 billion) and a minimum of 23 percent (\$11.1 billion) of the EITC total program payments are overclaims.

The IRS has a robust base enforcement program for the EITC which consists of examinations, math error notices, and document matching and has adopted a two-pronged approach to reduce improper payments:

- Seek opportunities to increase program efficiency within existing resources
- Test potential new approaches and processes and then request implementation funding if the tests prove successful

## RECOVERY AUDITING ACT

---

### Background

In accordance with the Recovery Auditing Act, OMB Circular A-123, Appendix C, requires agencies issuing \$500 million or more in contracts to establish and maintain recovery auditing activities and report on the results of those recovery efforts annually. Recovery auditing activities include the use of (1) contract audits, in which an examination of contracts pursuant to the audit and records clause incorporated in the contract is performed; (2) contingency contracts for recovery services in which the contractor is paid a percentage of the recoveries; and (3) internal review and analysis in which payment controls are employed to ensure that contract payments are accurate.

For Recovery Act compliance, Treasury requires each bureau and office to review their post-payment controls and report on recovery auditing activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use recovery auditing firms to perform many of the steps in their recovery program and identify candidates for recovery action.

### Results for Fiscal Year 2008

During fiscal year 2008, \$5.0 billion in contracts (defined as issued and obligated contracts, modifications, task orders, and delivery orders) were issued. Improper payments in the amount of \$825,279 were identified from recovery auditing efforts, and \$839,818 has been recovered, including prior year recoveries, with \$1,834 outstanding as accounts receivable on September 30, 2008.

Note: Additional detail on Treasury's IPIA and Recovery Auditing Act Program can be found in [Appendix B](#).

*This page left intentionally blank*

# MANAGEMENT ASSURANCES

## *The Secretary's Letter of Assurance*

The Department of the Treasury's management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). Treasury has evaluated its management controls, internal controls over financial reporting, and compliance with federal financial systems standards. As part of the evaluation process, we considered results of extensive testing and assessment across the Department and the results of independent audits.

Treasury provides reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act over operations have been achieved, except for the material weaknesses noted below. In accordance with OMB Circular A-123, Appendix A, we provide qualified assurance that internal control over financial reporting is effective as of June 30, 2008. Treasury is not in substantial compliance with the Federal Financial Management Improvement Act due to the material weakness involving revenue accounting systems; this weakness is a significant reason for our qualified overall assurance level for A-123, Appendix A.

Treasury has four remaining material weaknesses as of September 30, 2008, as follows:

### **Operations:**

#### *Internal Revenue Service*

- Systems modernization management and controls
- Systems security controls

#### *Financial Management Service*

- Systems, controls, and procedures to prepare the Government-wide financial statements

### **Financial Reporting:**

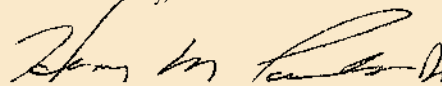
#### *Internal Revenue Service*

- Revenue accounting systems

The Department made significant progress during fiscal year 2008 by closing two of six material weaknesses. For the sixth straight fiscal year, we identified no new material weaknesses. We will continue to focus on achieving positive results by:

- Emphasizing internal control program responsibilities throughout Treasury
- Ensuring senior management attention to management controls
- Focusing on the need to develop and carry out responsible plans for resolving weaknesses

Sincerely,



Henry M. Paulson, Jr.

November 17, 2008

# MATERIAL WEAKNESSES, AUDIT FOLLOW-UP, AND FINANCIAL SYSTEMS

## SUMMARY OF MANAGEMENT ASSURANCE

Summary of Material Weaknesses						
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Revenue Accounting Systems	1	0	0	0	0	1
IRS - Systems Modernization Management and Controls	1	0	0	0	0	1
IRS - Overclaims in the Earned Income Tax Credit Program	1	0	1	0	0	0
IRS - Systems Security Controls	1	0	0	0	0	1
FMS - Systems, Controls and Procedures to Prepare the Government-wide Financial Statements	1	0	0	0	0	1
DO - Systems Security	1	0	1	0	0	0
<b>TOTAL MATERIAL WEAKNESSES</b>	<b>6</b>	<b>0</b>	<b>2</b>	<b>0</b>	<b>0</b>	<b>4</b>

During fiscal year 2008, Treasury closed two material weaknesses: Treasury Departmental Offices Lack of Compliance with the FISMA, and IRS Overclaims in the Earned Income Tax Credit.

As of September 30, 2008, Treasury has four remaining material weaknesses under Section 2 of the FMFIA as shown in the tables below.

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Qualified Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Revenue Accounting Systems	1	0	0	0	0	1
<b>TOTAL MATERIAL WEAKNESSES</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1</b>

Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	Qualified Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Systems Modernization Management and Controls	1	0	0	0	0	1
IRS - Overclaims in the Earned Income Tax Credit Program	1	0	1	0	0	0
IRS - Systems Security Controls	1	0	0	0	0	1
FMS - Systems, Controls, and Procedures to Prepare the Government-wide Financial Statements	1	0	0	0	0	1
DO - Systems Security	1	0	1	0	0	0
<b>TOTAL MATERIAL WEAKNESSES</b>	<b>5</b>	<b>0</b>	<b>2</b>	<b>0</b>	<b>0</b>	<b>3</b>

Conformance with Financial Management System Requirements (FMFIA § 4)						
Statement of Assurance	Systems conform to financial management system requirements					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
<b>TOTAL NON-CONFORMANCES</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

Compliance with Federal Financial Management Improvement Act (FFMIA)		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. System Requirements	No	
2. Accounting Standards	No	
3. USSGL at Transaction Level	No	

### Federal Managers' Financial Integrity Act (FMFIA)

The management control objectives under FMFIA are to reasonably ensure that:

- programs achieve their intended results
- resources are used consistent with overall mission
- programs and resources are free from waste, fraud, and mismanagement
- laws and regulations are followed
- controls are sufficient to minimize any improper or erroneous payments
- performance information is reliable
- system security is in substantial compliance with all relevant requirements
- continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels
- financial management systems are in compliance with federal financial systems standards

Deficiencies that seriously affect an agency's ability to meet these objectives are deemed "material weaknesses." Treasury can provide reasonable assurance that the objectives of FMFIA have been achieved, except for the remaining material weaknesses noted in the Secretary's Letter of Assurance. The last identified material weakness is targeted for closure in fiscal year 2012.

Each year material weaknesses, both the resolution of existing ones and the prevention of new ones, receive special attention. Over the past six years, Treasury has made great progress in reducing the number of material weaknesses. During fiscal year 2008, the Department closed two of six material weaknesses and continues to make resolution of these weaknesses a performance requirement for every executive, manager, and supervisor.

### Office of Management and Budget (OMB) Circular A-123, Appendix A

The Department continues to strengthen and improve the execution of the Treasury mission through the application of sound internal controls over financial reporting. In response to OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, Treasury developed and implemented an extensive testing and assessment methodology that identified and documented internal controls over financial reporting at the transaction level integrated with the Government Accountability Office's Standards for Internal Control. The testing and assessment were completed across all material Treasury bureaus and offices by June 30, 2008. Treasury provides qualified reasonable assurance that internal controls over financial reporting are effective as of June 30, 2008, due in large part to the revenue accounting system weaknesses at the IRS.

## Federal Financial Management Improvement Act (FFMIA)

FFMIA mandates that agencies “... implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger at the transaction level.” FFMIA also requires that remediation plans be developed for any entity that is unable to report substantial compliance with these requirements.

As of September 30, 2008, the Treasury Department’s financial management systems were not in substantial compliance with FFMIA due to deficiencies with the IRS’s financial management systems. The IRS has a remediation plan in place to correct the deficiencies. For each FFMIA recommendation, the remediation plan identifies specific remedies, target dates, responsible officials, and resource estimates required for completion. This plan is reviewed and updated quarterly. (Refer to Appendix D for detailed information.)

## Audit Follow-Up

During fiscal year 2008, Treasury placed a renewed emphasis on improving both the general administration of management control issues throughout the Department and the timeliness of the resolution of all findings and recommendations identified by the Office of the Inspector General (OIG), the Treasury Inspector General for Tax Administration (TIGTA), the Government Accountability Office, and external auditors.

Treasury management at every level will maintain the momentum on accomplishing Planned Corrective Actions (PCAs) timely to resolve and implement sound solutions for all audit recommendations. Although the Department has made great progress, considerably more work lies ahead to integrate the effects of those actions more fully into management’s decision-making processes. The Department needs to identify more precisely what it costs to accomplish Treasury’s varied missions and develop ways to improve overall performance. This will entail building upon the progress already made in expanding the communica-

tion and coordination among the Treasury offices variously involved in strategic planning, budget formulation, budget execution, performance management, and financial management.

## Financial Management Systems Framework

The Department’s overall financial management systems framework consists of a Treasury-wide financial data warehouse, supported by a financial reporting tool and separate bureau financial systems. Bureaus submit their monthly financial data to the data warehouse within three business days of the month-end. The Department then produces monthly financial statements and reports for management analysis. This framework satisfies both the bureaus’ diverse financial operational and reporting needs, as well as the Department’s internal and external reporting requirements. The financial data warehouse is part of the overarching Treasury-wide Financial Analysis and Reporting System (FARS), which also includes applications for bureaus to report the status of their performance measures and the status of their planned audit corrective actions. Treasury has also implemented a budget application which is used by the Departmental Offices (DO) in the management of DO’s budget expenditures. Additional FARS applications are planned to improve the Department’s financial management and operations. This includes asset management and enhanced reporting functionality.

Treasury’s FARS applications operate at a contractor operated hosting facility. In accordance with the guidance contained in the American Institute of Certified Public Accountants’ Statement of Auditing Standards (SAS) No. 70, *Service Organizations*, the service provider’s independent auditors examined the controls for the dedicated hosting service. In the opinion of the auditors, the description of the controls presents fairly, in all material respects, the relevant aspects of the provider’s controls that had been placed in operation as of September 30, 2008. Also, the controls described are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily and customer organizations applied

the controls contemplated in the design of the provider's controls.

The Department continues to enhance its financial management systems structure. As of September 30, 2008, the number of financial management systems decreased to 60, down from 64 at the end of fiscal year 2007.

The Bureau of the Public Debt's Administrative Resource Center (ARC) has been designated by OMB as a Financial Management Line of Business Shared Service Provider (SSP). The ARC currently services 28 federal entities for core financial systems, including twelve Treasury bureaus and reporting entities. Treasury will continue to evaluate opportunities to consolidate financial management systems and better utilize existing resources. The Department will work with the remaining bureaus to develop plans to migrate to a SSP for core financial systems in accordance with the Financial Management Line of Business requirements.

The ARC also provides systems and service support to eleven Department bureaus in the processing of their travel needs as part of the Department's E-Gov Travel initiative. Of the three remaining bureaus, two are exempt from the Federal Travel Regulations and do not plan to migrate at this time. The IRS, which is not cross-serviced

by the ARC, began a phased implementation to the E-Government travel system in May 2008.

The Department's FARS applications are also used to support other federal agencies. Treasury currently hosts another federal agency for consolidated financial processing and reporting. As a result of this arrangement, Treasury is able to share costs for the maintenance and operation of the FARS applications. In addition, the Department has demonstrated various FARS applications to other agencies. Several of the agencies have implemented FARS applications to run in their own systems environment, reducing their capital investment in systems software development.

*This page left intentionally blank*